Independent Audit Association

Findings, recommendations, and other matters related to the following:

- Examination of costs charged to the State Water Facilities as of December 31, 2007
- Preliminary analysis of costs incurred for the calendar year 2008
- Examination of the Statement of Charges provided by the Department of Water Resources dated July 1, 2008

December 19, 2008

Ernst & Young

Quality In Everything We Do

TABLE OF CONTENTS

TABLE OF CONTENTS
(Continued)

TABLE OF CONTENTS
(Continued)

SECTION **PAGE NO.**

TABLE OF CONTENTS
(Continued)

SECTION		PAGE NO.
4	**DETAILED DISCUSSION OF THE 2008 REGULAR PROCEDURES (CONTINUED)**	

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December 19, 2008

The Members of the
Independent Audit Association

In this document, we present the findings and recommendations from our procedures and other services performed for your agency, as a member of the Independent Audit Association (IAA), during 2008. Our services included an analysis of the costs for the State Water Project for 2007 and the reimbursable costs charged by the Department of Water Resources (the "Department"), which are to be paid by your agency in fiscal year 2009.

During the past and current year, we have periodically reported the status of our findings and recommendations to IAA representatives, with particular emphasis on matters requiring current resolution. Our findings and recommendations have also been presented to the Department's staff. We have included an Executive Summary for your convenience, which outlines the matters we believe are of most importance.

We will continue to assist the members of the IAA in resolving the many significant open matters and will pursue improved accuracy of State Water Project costs for the protection of the IAA members.

Very truly yours,

SECTION 1

EXECUTIVE SUMMARY

The following pages summarize certain significant matters contained in this report relating to the Ernst & Young (EY) 2008 procedures. Certain items represent cost savings or potential cost savings, which can be specifically identified, while others represent misallocations between cost component types (i.e., variable, minimum, capital) or policy-level issues; however, it should not be assumed that the items with dollar values attached represent the only cost savings to be realized by the members of the Independent Audit Association (IAA) as a result of our services.

We believe that many of the largest cost savings are ultimately achieved through the State Water Contractors' ("SWCs" or "Contractors") and our involvement in various committee meetings and other forums where significant matters are discussed with the Department of Water Resources ("DWR" or the "Department") as part of the formulation of formal policies and procedures.

GLOSSARY

This glossary contains terms used within this report and is included for your reference purposes.

Ag	Agricultural or Agriculture
B-Table	Bulletin 132 Appendix B
BDAC	Bay Delta Advisory Council
BDCP	Bay Delta Conservation Plan
CalATERS	The State's Automated Travel Expense Reimbursement System
CALFED	California Water Policy Council and Federal Ecosystem Directorate
CAL-ISO	California Independent System Operator
CARA	Cost Allocation and Repayment Analysis System
Contract(s)	Water Supply Contract(s)
Contractors or SWC	State Water Contractors
CVP	Central Valley Project
CWF	California Water Fund
Department or DWR	Department of Water Resources
DHCCP	Delta Habitat Conservation and Conveyance Program
DOE	Division of Engineering
DOF	Department of Finance
DWC	Delta Water Charge
DWR or Department	Department of Water Resources
EIR	Environmental Impact Report
EPGs	Enterprise Process Guides

EY	Ernst & Young
FALPOC(s)	Final Allocation of Power Cost(s)
Fiscal	Division of Fiscal Services
FOSO	Funds Oversight and Support Office
GOA	General Operating Account
GM	General Management
IAA	Independent Audit Association
IT	Information Technology
JOC	Joint Operations Center
LM	Line Management
M&I	Municipal and Industrial
MWQI(s)	Municipal Water Quality Investigation(s)
NERC	North American Electricity Reliability Corporation
NPC	Nevada Power Company
OAP	Off-Aqueduct Power
O&M	Operations and Maintenance
OMP&R	Operations, Maintenance, Power, and Replacement
PALPOC(s)	Preliminary Allocation of Power Cost(s)
PAYGO	Pay-As-You-Go
PCD	Power Cost Distribution
PG&E	Pacific Gas and Electric
PIR	Project Interest Rate
POE	Pro-rated Operating Expenses
PUF(s)	Proportional Use Factor(s)
RAS	Replacement Accounting System
RMC(s)	Rate Management Credit(s)
SAP	Systems, Applications, and Products in Data Processing
SCO	State Controller's Office
SCE	Southern California Edison
SMIF	Surplus Money Investment Fund
SOC(s)	Statement(s) of Charges
SWC or Contractors	State Water Contractor(s)
SWP	State Water Project
SWPAO	State Water Project Analysis Office
UCABS	Utility Cost Accounting and Billing System
USBR	United States Bureau of Reclamation
WERC	Western Electricity Coordinating Council
WSRB	Water System Revenue Bond
WRRF	Water Resources Revolving Fund

PRIORITIZATION OF FINDINGS AND RECOMMENDATIONS

As a result of our procedures, as outlined in this report, we believe the following matters should be considered significant matters or findings and, therefore, priorities of the IAA and the various Contractors' working technical committees. These matters are as follows:

- The Department's current billing process documentation consists of significant working knowledge in a few select individuals with very little in writing. By creating detailed written procedures, the Department will improve its knowledge-sharing of the billing process within the Department, resulting in improved consistency and accuracy of the data, as well as providing the opportunity for the data to be generated in a more timely manner. The creation of detailed written procedures will also provide transparency for Contractor understanding. **We recommend the Department expand its formal written documentation of the billing process**.

- To take full advantage of the potential benefits of Systems, Applications, and Products in Data Processing (SAP), a continuous cycle of business process improvement efforts is required. Many of the more significant processes used to prepare the Contractors' bills are done offline and bypass the information technology (IT) systems. **We recommend the Department work to provide automated process choices and modify its IT systems to allow the preparation of the bills to be processed within SAP**.

- In order to provide greater confidence in the billing process used by the Department, a continuous effort should be undertaken to ensure that there are adequate internal controls in place and they are operating effectively. **We recommend the Department focus on improving internal controls surrounding the billing process, as well as addressing the control-related findings from the Department's internal audit department. Additionally, we recommend that all controls be formally documented**.

In addition to the items listed above, we also make reference to the following items that should be considered as action items to be addressed in the upcoming year by the appropriate committees.

Description	SWC Committee
Develop formal documentation for policies and procedures used in the various cost calculations and related allocations	Audit-Finance
Monitor the level of activity in Suisun Marsh and continue to request the State fund its 20% share of the costs	Audit-Finance, Advisory Committee
Resolve protest letter items. Continue to work with the Department to develop and implement a working process to resolve protest items	Audit-Finance, Advisory Committee
Ensure implementation of revised capitalization policy, including betterment criteria and appropriate financing access	Audit-Finance, Advisory Committee
Review the appropriate funding level needs for Replacement Accounting System (RAS) deposits for conservation and transportation RAS	Audit-Finance
Review charges to replacement accounts to ensure conformance with established policy on consistency of application methodology	O&M and Audit-Finance
Federal Energy Regulatory Commission re-licensing status and related program funding options (including allocation of repayment of costs)	Audit-Finance, Advisory Committee
Gas hedging account status and possible modifications to the existing program	Audit-Finance, Energy Policy Committee
Review off-aqueduct power (OAP) revenue assumptions and timing	Energy Policy Committee
Statements of Charges (SOCs) need to be supported by data within Bulletin 132, Appendix B (B-Tables), which must be issued at the time of the issuance of the SOCs	Audit-Finance
SOC reasonableness test using a comparative analysis spreadsheet to prior SOC amounts by Contractor including reason for changes to historical amounts	Audit-Finance
Development of a formalized process of timely generation of the rate management credit (RMC) schedule, which must include support for all numbers	Audit-Finance
$11.5 million owed to DWR by State	Audit-Finance, Advisory Committee
Tracking of Delta Habitat Conservation and Conveyance Program (DHCCP) costs	Audit-Finance
San Joaquin Valley Drain funding issue, regarding the capital facilities account	SWC Board of Directors
Amortization of capital costs over decreasing number of years, regarding the Water Supply Contract (Contract) end date of 2035	Audit-Finance/Advisory Committee/Contract Issues Committee

2008 SPECIAL PROCEDURES

This section of our report contains summaries of the findings resulting from our 2008 special procedures.

Delta Habitat Conservation and Conveyance Program Costs

The Department has begun expending money on the initial planning costs for the DHCCP. For a detailed description of the procedures performed to test these costs, please refer to Section 3. The following are the results of our procedures.

Findings and Results

Discussions at the November 4, 2008, Audit-Finance Committee meeting indicated that the Department is currently estimating a total of $8 million to be paid out by December 31, 2008. The plan is to include 50% of this projected spending (the SWC portion under the assumed 50% split with the United States Bureau of Reclamation (USBR)) in the December 2008 re-bill of the 2009 SOC. Based on the spending history shown below, it does not appear that $8 million will be spent by December 31, 2008.

Month	Total DHCCP Spent to Date (Cumulative)
April 30, 2008	$ 6,160
May 31, 2008	112,713
June 30, 2008	1,270,025
July 31, 2008	1,553,142
August 31, 2008	1,716,147
September 30, 2008	2,513,796
October 31, 2008	4,048,003
November 30, 2008	4,761,587

The following external consultants are currently being used by the Department:

- HDR, Inc. – HDR is an employee-owned architectural, engineering and consulting firm that helps clients manage complex projects.

- URS Corporation – URS is a publicly owned company that provides a range of planning, engineering and architectural design, environmental, construction, program and construction management, systems integration, operations and maintenance and management services.

- CH2M Hill – CH2M Hill is an employee-owned full-service engineering, consulting, construction and operations firm.

We selected six invoices from the SAP detail totaling $1.7 million for testing. We reviewed copies of these invoices, noting that four out of the six were clearly related to DHCCP. The other two invoices, both from HDR, Inc., (invoices #44255 and #53418 totaling $459 thousand) had notation that they related to the Bay Delta Conservation Plan (BDCP) and DHCCP. Through inquiry of the Department, we determined these costs were related to writing an environmental impact report (EIR). It was not clear that these costs were solely related to DHCCP from the invoice. The Department indicated that BDCP is covered under DHCCP. We were unable to obtain evidence to support this assertion prior to the date of this report.

We obtained copies of the contracts with the external consultants mentioned above, noting that there are currently total commitments of $93 million. Refer to Section 3 for detail of this amount by consultant.

As a funding agreement was not finalized during our current year procedures, we have not performed any testing in this area. The Department plans to withhold $13 million of the Springing Amendment funds to cover the 2008 DHCCP costs in the interim.

As no funds have been collected from the Contractors by the Department, we were unable to determine if appropriate measures are being taken to segregate funding for DHCCP from other projects.

Springing Amendment Calculation

In 2008, the Department determined that it achieved the required threshold to implement the revenue bond springing amendment, which reduces the bond reserve requirement and will result in the return of approximately $72 million to the Contractors. For a detailed description of the procedures performed to test the springing amendment, please refer to Section 3. The following are the results of our procedures.

Findings and Results

- The Department performed the calculation of the amount being released by the springing amendment based on information prior to the issuance of series AE. **We recommend the Department update the calculation to include all bond series issued and payments made to date**. By including series AE and reflecting the 2008 debt service payments in the calculation, we believe that the Department could free up an additional $5 million in debt service reserves that could be distributed to the Contractors.

- The asset balance in the debt service reserve fund as of October 31, 2008, was $187.8 million. **We recommend the Contractors monitor the amount and nature of the surplus that has accumulated in the debt service reserve fund and ensure that excess funds are returned as they become available**.

- The Department's analysis of the actual allocation of bond proceeds to Contractors was not available for our testing as of December 2008. As such, we were unable to test this as part of the current year procedures.

Delta Water Charge Calculation and Assumptions

The conservation facilities' operating costs shown in Bulletin 132, Table B-13 have increased significantly in the last 10 years. Table B-13 does not provide breakdowns of the total costs assigned to the conservation facilities capital costs and operating costs to provide visibility as to what cost categories are increasing. For a detailed description of the procedures performed to test the Delta Water Charge (DWC) calculation and assumptions, please refer to Section 3. The following are the results of our procedures.

Findings and Results

Please refer to Section 3 for the breakdown of the Bulletin 132-07, Table B-13 by year and category. The following table summarizes the total operating and capital costs per Bulletin 132, Table B-13 for the last 10 years:

Bulletin 132-XX	Total Operating Costs Per Table B-13	Increase (Decrease) from the Prior Year	% Change from the Prior Year	Total Capital Costs Per Table B-13	Increase (Decrease) from the Prior Year	% Change from the Prior Year
99	$2,667,492,808	$ (3,182,507)	(0.12%)	$1,052,864,965	$ 868,239	0.08%
00	2,679,230,475	11,737,667	0.44%	1,048,217,130	(4,647,835)	(0.44%)
01	2,722,024,514	42,794,039	1.60%	1,031,669,896	(16,547,234)	(1.58%)
02	2,753,382,670	31,358,156	1.15%	986,384,482	(45,285,414)	(4.39%)
03	2,793,100,623	39,717,953	1.44%	1,001,929,509	15,545,027	1.58%
04	2,816,519,086	23,418,463	0.84%	1,054,089,704	52,160,195	5.21%
05	2,878,130,450	61,611,364	2.19%	1,089,645,257	35,555,553	3.37%
06	2,997,740,079	119,609,629	4.16%	1,095,412,955	5,767,698	0.53%
07	3,094,655,083	96,915,004	3.23%	1,119,024,136	23,611,181	2.16%
08	3,469,705,439	375,050,356	12.12%	1,360,036,639	241,012,503	21.54%

One of the major contributors to the continual increase in operating costs as noted above is that the Department only projects detailed cost data for three years in the future (i.e., the 2009 SOC include projections for 2008-2010 based on an average of expenditures from 2005-2007). When preparing the 2009 SOC utilizing Bulletin 132-08, the State Water Project Analysis Office (SWPAO) began working toward including more accurate data in the future projections. Through our testing we noted the Department made the following changes in the current year:

- Leveled future costs under the Delta minimum (the Department previously had a step-down effect in future years). Additionally, the Department included a future estimate for extraordinary operations and maintenance (O&M) of approximately $4.5 million per year.

- Increased future costs related to the power costs associated with pumping water into the San Luis Reservoir. The future cost estimates were previously based upon power costs of approximately 15 mills. This was increased to 33 mills to be more consistent with current costs.

The capital costs are developed based on the capital budgets obtained from the Division of Engineering (DOE). These costs fluctuate depending on what projects obtain approval and the level of funding that they are granted.

We recommend that the Department and the Contractors continue to analyze the underlying assumptions being used to develop future cost estimates and update them as deemed appropriate.

We were unable to obtain support in order to group costs by reach into categories, such as direct salary and wages, overhead, direct pay, studies and consultants, as this type of breakdown is not readily available and would require significant Department resources to prepare. We were also unable to obtain categorized data and assumptions by reach used for the 2009 SOC for the time period 2008-2012 for the same reasons. **We strongly recommend that the Department work with the IT group to provide additional visibility into the costs within the DWC through management reports**.

Overhead Allocation

Overhead costs are distributed into four main categories. These categories are staff benefits, pro-rated operating expenses (POE), general management (GM) and line management (LM). Other overhead categories are rent and absences. Previously, the Department had a study performed related to overhead, which included recommendations. For a detailed description of the procedures performed to test overhead, please refer to Section 3. The following are the results of our procedures related to overhead allocation.

Findings and Results

See below for our calculation of total overhead costs to total operating expenses for 2005–2008 (amounts have been rounded for presentation purposes).

	2005	2006	2007	2008
Total overhead costs	$100,421,000	$105,252,000	$100,225,000	$100,144,000
Total operating expenses	578,381,000	783,683,000	772,125,000	845,500,000
Percentage	**17.4%**	**13.4%**	**13.0%**	**11.8%**

The budgeted amounts for 2009 were not uploaded into SAP until December 2008. As a result, we were unable to compare the historical costs to the future estimates.

We identified a drill-down issue within SAP while performing our procedures. This issue did not affect overhead costs but did affect the accuracy of the overhead reports being generated out of the system. **We recommend that the Department correct the reporting issue within SAP for all years that continue to be affected, including any past years**.

As of December 2008, we were unable to get a response from the Department as to whether any costs related to the FloodSafe program were being included in the staff benefits, POE or LM overhead categories. FloodSafe is an integrated flood management and emergency response system throughout California. We do not believe these costs should be treated as overhead as they do not benefit the State Water Project (SWP) as a whole.

IBM Report

In the current year, the Department provided responses to the findings noted in the IBM overhead report.

We noted that the Department did make some progress in the areas where IBM had identified issues. For example, in fiscal year 2006-2007 the Department developed and began using a methodology for distributing state pro-rata costs in a method that is similar to what was recommended by IBM. Additionally, management has decided to transition the Bryte Chemical Laboratory back to a direct charge service effective July 1, 2009, and has implemented a self-service Web-based portal in order to automate certain human resource tasks.

However, the Department has also determined that a number of the IBM recommendations are either not feasible or would not be cost-effective and thus will not be addressed. **We recommend that the Department continue to work toward providing additional visibility into overhead costs and make it a high priority to implement internal controls surrounding overhead, such as developing performance measures**. For additional details on the Department's responses to the findings in the IBM report refer to Section 3.

Debt Service Allocation

The Department has a process in place that it uses to allocate debt service to the projects for which it was originally issued. The debt service allocation to individual projects varies depending on whether the proceeds are being used to repay commercial paper (these amounts represent new money) or are being used to refund a preceding bond series. For a detailed description of the procedures performed to test the debt service allocation, please refer to Section 3. The following are the results of our procedures.

Findings and Results

The Department does not have formal documentation of the process used to allocate bond proceeds to the Water System Revenue Bond (WSRB) surcharge and relevant projects. **We strongly recommend that the Department work to formulate documentation of this methodology and process**. This will ensure that the allocation is consistent and done correctly.

The original interest allocation for series AB was prepared using an estimated interest rate of 4%, as the actual variable rates were unknown. **We recommend that the Department inform the Contractors when an estimated rate is used for an allocation, as this will cause fluctuations to debt service payments**. Refer to Section 3 for additional detail.

The Department was unable to show EY where the bond issuance costs and underwriter's discount (totaling $3.5 million for series AE) were included in the debt service schedule dated October 1, 2008. As of the date of this report, we were unable to determine if these costs were included. As a result, we are unable to determine the impact to the Contractors.

Rate Management Credit Calculation

Each year, the Department performs a "financial analysis," which is used to determine the excess revenues that are available to be distributed to the Contractors in the form of RMCs as provided under the terms of the Monterey Amendment. For a detailed description of the procedures performed to test the RMC calculation, please refer to Section 3. The following are the results of our procedures.

Findings and Results

- There is no formal documentation of the process for preparation of the RMC calculation, which we believe could result in inconsistencies and inaccuracies within the calculation. **We recommend that the Department work with the Contractors to create a detailed set of instructions for preparing the RMC calculation. We also recommend that the Department work to improve the informal instructions currently in place if no formal instructions will be created**.

- There were numerous items that we tested within the RMC calculation that were not supportable by the Department or were incorrect in the calculation. These items are as follows:

    - The Department was unable to provide support for the 2004 original over/under amount used in the calculation.

    - The "interest (credits)/charges on prior over/under payments" do not agree to the support provided for 2005 and 2006.

    - The "Devil Canyon-Castaic debt service transfer" amount does not agree to the support provided for 2005.

    - The "Delta Water Charge capital" amount for 2007 was calculated using incorrect support.

    - The "Minimum Conservation Costs" plus the "Minimum Conservation Cost Adjustment" do not agree to Bulletin 132-07, Table B-13 for 2005 and 2006.

    - There was conflicting support given for the "Original Recreation Allocation" for 2005. We were unable to discuss and resolve the difference in the reports with the Division of Fiscal Services (Fiscal) in the current year, as they were working to complete the Department's financial statements.

    - The "Delta Water Charge Revenue" amount for 2007 does not agree to the SOC. The Department was not aware of why the amounts had not been updated to reflect the March re-bill amount of $57.9 million.

  We recommend that the Department document the process to be used for accumulating the data utilized in the RMC calculation to ensure that the source is consistent from year to year, as well as retain the actual support generated that is input into the RMC calculation for each version. The Department should also periodically update the RMC calculation to reflect the most recent information.

2008 REGULAR PROCEDURES

This section of our report contains summaries of the findings resulting from our 2008 regular procedures.

Off-Aqueduct Power Facilities

In an effort to provide the SWP with a cost-effective energy supply, the Department has participated in several OAP facilities. These facilities have included Reid Gardner Unit 4 (a coal burning facility), and the Bottle Rock and South Geysers Geothermal Power Plants. Since December 1990, only the Reid Gardner facility has been producing energy. For a detailed description of the procedures performed to test the OAP facilities, please refer to Section 4. The following are the results of our procedures.

Findings and Results

The Department does not estimate power revenues in the initial or May allocation of OAP facilities charges, resulting in over-collections from the Contractors. **We recommend that the Department include a preliminary estimate of revenues in the initial allocation of OAP facilities charges, and update this estimate in the May allocation to minimize over-collections from the Contractors**.

Under the Department's current process for OAP, the shortest time lag between the end of a billing period and the issuance of refund notices or additional billings is two years. The refunds or billings resulting from the final true-up of costs do not occur until three years subsequent to the end of a billing period (for example, the billing related to the 2006 final year-end allocation will not occur until 2009). There is currently an under-billing related to 2006 of $1.2 million and a refund related to 2007 of $29.3 million that have not been settled with the Contractors. **We recommend the Department reduce this lag to provide a timely settlement with the Contractors**.

An additional $1.6 million was included in the Reid Gardner O&M costs within the 2007 preliminary year-end allocation in anticipation of future invoices. We obtained a breakdown of the $1.6 million and noted that there was no support for $500 thousand of the costs. We recommend that the Department refrain from including unsupported cost estimates in the preliminary year-end allocation as the allocation is prepared numerous months after the end of the previous calendar year (i.e., the 2007 preliminary year-end allocation was finalized in August 2008) and should no longer rely on unsupported estimates.

Costs related to 2008 of approximately $366 thousand were incorrectly included in the preliminary year-end allocation of 2007 OAP facilities charges. **We recommend that the Department follow accrual-based accounting and adjust these costs to match the proper service periods**.

Delta Water Rate

Contractors are charged for the capital and minimum costs of building, operating and maintaining the SWP's water storage (conservation) facilities through the DWC. For a detailed description of the procedures performed to test the DWC, please refer to Section 4. The following are the results of our procedures.

Findings and Results

The future projections used in the DWC are not auditable due to the inclusion of estimates in the future years' costs. **We recommend the Department allocate sufficient resources toward incorporating sound documentation standards to clearly document changes in the DWC**. As part of the billing process, we suggest that the Department prepare an analysis of all charges affecting the DWC, such as a listing of each cost center affecting the DWC and the allocation of the cost center between the DWC and other repayment methods.

The capital component included manual additions of $200 million related to the costs to implement an amendment to the Four Pumps Agreement, which is to further mitigate fish loss at the Delta Pumping Plant. The minimum component included manual additions of $128 million related to the future cost estimates for the DHCCP. The Department has indicated that it will remove the DHCCP costs from the DWC in the December re-bill. We recommend that the Department also remove the costs related to the Four Pumps Agreement, as there is no support for the cost estimates currently being included in the capital component. We estimate this would result in a decrease to the Bulletin 132-08 capital cost component of the DWC of approximately $2.47 per acre-foot.

As part of our procedures, we attempted to obtain explanations for significant fluctuations in the DWC. The Department was not able to provide adequately detailed explanations for the following changes in the SAP data pulled for Table B-13 between the current year and the prior year:

Capital Component

- The future costs for 2013 increased by $1.2 million under the Delta component.
- The future costs for 2009 increased by $1.4 million under the California Aqueduct and San Luis component.

Through discussions with the Department, we determined that the capital amounts noted above changed due to updated future projections from the capital budgets. However, we were not able to obtain the capital budgets used to compile the current year figures prior to the completion of our procedures.

Minimum Component

- The future costs for 2008 and 2010 decreased by $6.2 million and $12.2 million, respectively, under the Oroville component.
- The future collections (resulting in related credits to the DWC) for 2008, 2009, and 2010 increased by $3.3 million, decreased by $1.5 million, and decreased by $7.1 million, respectively, under the Oroville Power Revenue component.
- The future costs for 2009 and 2010 increased by $4.4 million and $18.9 million, respectively, under the California Aqueduct and San Luis component.

Through discussions with the Department, we determined that the minimum amounts noted above changed due to revised future projections. Minimum costs are projected three years into the future. In the current year, projections were updated for 2008–2010. We obtained the Department's calculation and tied out the current year amounts for the Oroville and the California Aqueduct and San Luis components; however, could not identify the specific reasons behind the large changes from last year's estimates. We recommend that the Department provide additional visibility in the changes that occur to the DWC from year to year.

The Table A entitlement water within the "Entitlement Water Present Worth to 2008" schedule differed from Bulletin 132-08, Table B-4 by 9,900 acre feet. We determined that this difference does not have a significant monetary impact (less than $10 thousand on the total present worth); however, the two schedules should be in agreement.

The Department's current methodology of computing the DWC fails to acknowledge that Contractors make semi-annual capital and monthly minimum payments and, therefore, deprives them of any related interest benefits. Based on our preliminary assessment, we calculated that the present value of interest benefits foregone to date are approximately $66.8 million for the minimum component and $52.7 million for the capital component. This calculates to a $1.91 per acre-foot impact on the DWC. **Therefore, we strongly recommend the Contractors and the Department amend this computation provision of the Contract in consideration of the matters discussed above**.

Transportation Charges

Transportation charges relate to the transportation of water through SWP facilities. The annual charge to each Contractor represents each Contractor's proportional share of the reimbursable capital and operating costs of the SWP transportation facilities built for delivering water to individual Contractors. For a detailed description of the procedures performed to test the transportation charges, please refer to Section 4. The following are the results of our procedures.

Findings and Results

During our procedures, we determined that amounts were incorrectly entered in the electronic version of the B-Tables. As the printed B-Tables had not yet been published at the time the error was discovered, the Department was able to correct the amounts for the printed version.

Tables B-1 and B-2 do not reflect the effect of permanent water transfers. **We recommend that the Department develop and publish a report showing the proportional use factors (PUFs) by reach related to permanent water transfers**. This would enable those Contractors who receive permanent water transfers to recalculate their capital transportation charges for a given year using the Bulletin 132 data.

Tables B-1 and B-2 do not include the East Branch Extension. The Department included a discussion surrounding this item, including the cumulative rate factors for the East Branch Extension in the text prefacing the B-Tables in Bulletin 132-08, Appendix B. **We recommend that the Department update and publish Table B-1 and Table B-2 to include the East Branch Extension**. This will provide the users of Bulletin 132 with the most beneficial information, as all of the relevant data will be located in one place.

The transportation variable charge per the SOC Attachment 4C for two of the three Contractors selected for testing by EY did not appear to be calculated correctly in the SOC. Through discussions with the Department, we determined that the charges for San Bernardino were based on out-of-date information. The Department has indicated that it will correct this in the December 2008 re-bill. The Department was still in the process of investigating the Kern County Water Agency amounts; however, the Department stated that it will aim to resolve it prior to the December 2008 re-bill and include updated amounts at that time.

As part of our reach cost testing in 2007, we attempted to compare minimum costs recorded in SAP for Reach CA 29G for 2006 to the amount listed at Table B-11 of Bulletin 132-07. At that time, we were unable to recalculate the reach amount in 2007 using SAP data. In 2008, we re-pulled the data from SAP, and obtained a total of $5,122,521. We compared this amount to the Bulletin 132-08 value for Reach CA 29G for 2006, noting the amount in Table B-11 had increased to $5,130,725. We inquired as to the reason for the increase in the amount from the Bulletin 132-07 data to the Bulletin 132-08 data. The Department was unable to provide the specific reason for the increase; however, the Department speculated that it resulted from issues related to the migration to the new SAP system.

We were unable to recalculate the transportation variable costs per Table B-12 for the reaches selected using SAP for all three of our selections in the current year. We requested the supporting calculations for the reaches and years selected; however, we did not obtain them for testing prior to the conclusion of our 2008 testing. The Department has indicated that it will recalculate the Table B-12 costs using SAP for the December 2008 re-bill.

We were unable to recalculate the 2007 unit rate per Bulletin 132-08, Table B-17 for the Mojave Siphon Powerplant using Bulletin 132-08, Table B-6 and Table B-12, as the amount in Table B-6 is incorrect. Through discussions with the Department, we determined that the amount in Table B-6 is an estimate and has not been properly updated. The Department has indicated that this will be trued-up in Bulletin 132-09.

Proportional Use Factors

PUFs are factors used for distributing reach capital costs and reach minimum operations, maintenance, power, and replacement (OMP&R) costs among the Contractors. For a detailed description of the procedures performed to test the PUFs, please refer to Section 4. The following are the results of our procedures.

Findings and Results

After review of Tables B-1 and B-2, we noted that there were not any reportable findings.

Monterey Amendment

In December 1994, a package of principles was negotiated to serve as a foundation to settle disputes over water allocations and certain operational and financial aspects of the SWP. This foundation is established in "The Monterey Agreement – Statement of Principles," which was incorporated in a subsequent Contract amendment. For a detailed description of the procedures performed to test the Monterey Amendment, please refer to Section 4. The following are the results of our procedures.

Findings and Results

As of December 2008, the Department had not finalized the amount of the 2009 RMCs. **We recommend that the Department determine the RMC amount and related allocation in a more timely manner to ensure that the correct amounts are reflected in the Contractors' monthly bills and allow the Contractors time to plan for the amounts they will ultimately receive**.

The RMC allocation is prepared utilizing Table B-15 data, excluding the effect of permanent water transfers. However, Table B-15 presented in Bulletin 132 includes the effect of permanent water transfers. **In order to provide the most meaningful information and allow the users of the B-Tables to recalculate the RMC allocation, we recommend that the Department present the B-Tables both pre- and post- water transfers**.

The Coastal Branch Extension and East Branch Extension costs are calculated manually and then added into Table B-15. As such, we were unable to agree these amounts to SAP. **We**

recommend that the Department work toward a solution that includes each component in calculating the B-Tables within SAP.

Adjustments were included in the 2008 RMC allocation for municipal & industrial (M&I) Contractors to correct errors in previous years' calculations; however, the rationale used to make the adjustments was not clearly documented. **We recommend that on a go-forward basis the Department retain detailed documentation supporting the calculation of adjustments to the RMC allocations**.

The 2005 and 2006 RMC allocations were prepared using the incorrect B-Tables. **We recommend that the Department reallocate these amounts to the appropriate Contractors in order to be in compliance with the Monterey Amendment**.

We recommend the Department continue to work with the Contractors to ensure the allocation methodology of the RMCs is in accordance with the Monterey Amendment. We also recommend any changes to the processes outlined in the Monterey Amendment (such as continuing to use the allocation percentages based on Bulletin 132-99 rather than updating them to the Bulletin 132-04 data) be documented in writing and communicated/verified through a Notice to the Contractors.

There is a general lack of controls surrounding the agricultural (Ag) rate management trust funds. **We recommend that the Department designate an individual that is familiar with the trustee agreements to monitor activity and account balances within these funds**. The Department should also designate someone responsible for providing the trustees with the needed information to determine compliance with the terms and conditions of the Contract. **Alternatively, if there is no longer a viable reason to maintain these funds, we recommend they be terminated through a Contract amendment**.

Water System Revenue Bond Surcharge

The annual charges to recover the WSRB financing consist of two elements. The first element is the annual charge to the Contractors for repayment of capital costs of water system facilities at the project interest rate (PIR). The second component is the Contractors' share of the WSRB surcharge to be paid in lieu of a PIR adjustment. The surcharge is the difference between the repayment of the total annual capital costs of water system facilities at the PIR and the total annual financing costs of the WSRB. For a detailed description of the procedures performed to test the WSRB Surcharge, please refer to Section 4. The following are the results of our procedures.

Findings and Results

The WSRB surcharge calculation is performed outside of the system and is based on historical factors and ratios, which the Department believes have not changed since the year they were developed.

The WSRB surcharge for the 2009 SOC was calculated using estimated values for series AE, which resulted in a misstatement of the WSRB surcharge. The Department has indicated that it will update these amounts to the actual figures in the December 2008 re-bill. Our calculation, based on October 2008 data obtained from the Department, projects an overall decrease to the WSRB surcharge of approximately $1.4 million.

Statement of Charges

The Department prepares the Contractors initial SOC on July 1 each year for the subsequent year (i.e., the 2009 SOC was prepared July 1, 2008). For a detailed description of the procedures performed to test the SOC, please refer to Section 4. The following are the results of our procedures.

Findings and Results

The acre-feet amounts per Attachment 1 for Kern County Water Agency – Ag and Kern County Water Agency – M&I do not agree to the 2009 amount per Bulletin 132-08, Table B-4. These amounts are for informational purposes only and do not affect actual charges. The actual charges are picked up from Attachment 1, including both Ag and M&I charges. **We**

recommend that the amounts be corrected on the re-bill in order to provide Kern County Water Agency with accurate data.

The 1993-2009 calculated component amounts per Attachment 4A of Santa Barbara County Flood Control and Water Conservation District did not agree to Bulletin 132-08, Table B-15. **We recommend that this schedule, or a similar one showing the combination of charges, be included as part of the Bulletin 132 Tables, which are provided to the Contractors so that they can determine if their charges are correct**.

The 2001 and 2006 calculated component amounts per Attachment 4B for Kern County Water Agency – Ag did not agree to SAP as SAP does not include relinquished capacity. **We recommend that the Department include this and all similar schedules showing charges associated with relinquished capacity as a supplement to the Bulletin 132 Tables**.

We identified seven instances (two each from Kern County Water Agency – M&I, Kern County Water Agency – Ag and Santa Barbara County Flood Control and Water Conservation District and one from Mojave Water Agency) in which the "Annual Quantities Delivered or Requested" per Attachment 4C did not agree to Bulletin 132-08, Table B-5B. Although there was no effect on the amount billed because the correct deliveries were used in calculating the calculated components, **it is our recommendation that the attachments be updated to show the correct annual quantities delivered**.

We identified seven instances (one from Mojave Water Agency, one from Alameda County Water District and five from Kern County Water Agency – Ag) where the "Annual Quantities Delivered or Requested" did not agree to Bulletin 132-08, Table B-5B (which does not take water credits into account). These amounts did agree to an offline schedule showing annual quantities with water credits. **We recommend that this schedule be published in some format (e.g., as an appendix, additional table, etc.) in conjunction with Bulletin 132**.

Eighteen of the 30 calculated component amounts we selected for testing from Attachment 4C did not agree to SAP. The Department had not provided a response as to why these amounts did not agree to SAP as of December 2008.

The payments received for 2003 and 2004 per Mojave Water Agency's Attachment 4E changed from the prior year SOC. We were unable to obtain an explanation of these variances from the Department.

The Department did not use the most current B-Tables in the 2008 allocation of BDCP charges. **We recommend that the Department use the most current amounts in its calculations and update these calculations as new information becomes available**.

Municipal water quality investigation (MWQI) charges were added to the 2008 and 2009 SAP minimum component totals manually. However, these charges, totaling $3.1 million in 2008 and $3 million in 2009 had previously been entered into SAP and were thus being included twice in the minimum component. The Department has indicated that it will correct this in the re-bill.

New and Changed Cost and Fund Centers

The purpose and use of fund and cost centers as well as the procedures surrounding these items are detailed in Enterprise Process Guides (EPGs) published by the Department for internal use. For a detailed description of the procedures performed to test the new and changed cost and fund centers, please refer to Section 4. The following are the results of our procedures.

Findings and Results

The Department is not consistently following the procedures required to create or update cost and fund centers. We tested 25 new and changed cost centers created in 2007 and noted only five were created in accordance with the required methodology. **We recommend that the Funds Oversight and Support Office (FOSO) ensure all approval forms are appropriately completed for any circumstances where exceptions are not stipulated**.

KB-15 Entries

Manual KB-15 entries are currently made for items such as wheeling credits, rental income, Preliminary Allocation of Power Cost (PALPOC) adjustments and USBR payments. For a detailed description of the procedures performed to test KB-15 entries, please refer to Section 4. The following are the results of our procedures.

Findings and Results

In the current year, we had difficulty obtaining a complete listing of KB-15 entries. This was primarily due to turnover of Department personnel. **We recommend that the Department create standard procedures for pulling the KB-15 entries and any other processes deemed necessary**. We were ultimately able to obtain this listing in November 2008 and completed our testing noting no additional findings.

Project Interest Rate

The PIR is primarily used by the Department for all transportation and conservation calculations in order to determine the present value of water and money. For a detailed description of the procedures performed to test the PIR, please refer to Section 4. The following are the results of our procedures.

Findings and Results

There were no reportable findings as a result of our procedures performed on the PIR.

Internal Audit

During 2008, Internal Audit issued two reports, the internal control review and the review of the Department's UNIX server security. For a detailed description of the procedures performed to test internal audit, please refer to Section 4. The following are the results of our procedures.

Findings and Results

Through our review of the Internal Audit report on internal controls, we noted weaknesses in the Department's cash receipts, revolving fund, cash disbursements, receivables, purchases, fixed assets, financial statement and personnel processes, which could affect the accuracy of the Contractors' bills.

Noteworthy findings are summarized below:

- The personnel responsible for receiving checks do not always forward these checks to the cash receipts sections in a timely manner. Additionally, the field offices do not always deposit checks in a timely manner with the State Treasurer's Office per the policy. As a result, interest income is lost.

- There is a lack of separation of duties within the purchasing process.
- There is a lack of separation of duties within the SAP human resource processes.
- Within the last three years (as of the Internal Audit report date), there had not been a department-wide fixed asset inventory completed. This could result in inaccurate fixed asset accounting data.

Through our review of the Internal Audit report on the UNIX server security, we noted that the Department does not appear to have proper security controls in place over who has access to the server.

We recommend that the Department follow the Internal Audit recommendations for internal controls and continually review its processes to ensure controls are in place and functioning properly.

Replacement Accounting System

Under the Pay-As-You-Go (PAYGO) system, transportation facility-related replacement costs are collected through the variable OMP&R component of the transportation charge. There were no costs for conservation replacements in the 2007 through 2009 SOCs. For a detailed description of the procedures performed to test replacements, please refer to Section 4. The following are the results of our procedures.

Findings and Results

In the current year, the Department expressed that there had been changes to the PAYGO process. However, it did not comply with our request for information regarding the nature of these changes.

The meeting to assess the reserve balance was intended to occur annually beginning in 2001; however, this meeting has not taken place in recent years.

The acre-feet quantity in the water through plant allocation did not agree to Bulletin 132-08, Table B-5B for three out of five of the Contractors selected. Although the correct total was billed by the Department, this error resulted in misallocation of the costs to the Contractors. This inaccuracy was due to a processing error in SAP. As the bills are generated by amounts pulled from SAP, this issue raises questions as to the accuracy of other amounts pulled from this system. The Department has indicated that it will correct the allocation in the December re-bill.

The rotating rate was incorrectly used to calculate the replacement cost of stationary equipment at the Chrisman plant. Although this did not have a large impact on any one Contractor (the largest impact was $1,047), the Department should implement sufficient controls to catch this type of error. The Department indicated that the correction for this error will be made when actual costs are determined and allocated. However, as the Department has resolved to correct the error discussed in the previous finding at the time of the re-bill, **we recommend that this error be corrected at that time as well in order to present the most accurate estimation of costs**.

Replacement charges in Attachment 5 of the SOC were reversed for Alameda County Flood Control & Water Conservation District Zone 7 and Alameda County Water District, and Kern County Water Agency – Ag and Kern County Water Agency – M&I. The Department has indicated that it will correct these errors in the December re-bill.

The conservation fund does not accurately reflect the $5 million that was collected to replenish it. **We recommend that the Department work to properly account for the conservation fund as soon as possible and reevaluate the need for the fund. In addition, we recommend that the Department coordinate between internal departments more effectively so that situations such as this are not overlooked and unresolved**.

System Power Costs

A summary of power costs and revenues for each year, including costs assigned to the value of recovery generation and energy transmission, is prepared by SWPAO and presented in a memorandum entitled "Preliminary Allocation of Power Costs" (PALPOC). Once the costs for a year are finalized, a "Final Allocation of Power Costs" (FALPOC) is issued. For a detailed description of the procedures performed to test system power costs, please refer to Section 4. The following are the results of our procedures.

Findings and Results

The process used to accumulate power revenues and expenses for inclusion in the SOCs is manual and requires a significant amount of time and effort. This results in delays of information and a higher potential for errors.

As of December 2008, the Department has not begun using Power Cost Distribution (PCD) to generate the FALPOCs.

The 1999–2007 FALPOCs have not been completed. **We recommend that the Department work to issue the FALPOCs within a more reasonable time period**. A possible option would be to issue additional billings or refunds based on the preliminary allocation, similar to the process used for OAP. The FALPOCs generally result in either an additional billing or a refund to Contractors, and the delay in finalization could result in cash flow issues for the Department or deprive Contractors of use of any funds being returned.

The Joint Operations Center (JOC) recorded power expenses totaling $142,670 related to a California Independent System Operator (CAL-ISO) contract that were not included in SWPAO Table 5. Although the fees were ultimately reassessed for inclusion, the circumstances detailed in Section 4 exemplify the potential for errors within the current process, where multiple sets of data are kept by separate departments.

A distribution of $121,161 from the Enron bankruptcy settlement was excluded from the current version of the 2000 FALPOC. As the Department received this distribution, and the 2000 FALPOC has not been finalized, **we recommend that the 2000 FALPOC be updated to reflect the $121,161 Enron distribution**.

Through our testing of the PALPOC to SAP reconciliation, we noted that SWPAO listed December 2007 Nevada Power Company (NPC) revenues totaling $1,351,989, while SAP recorded only $301,786. Additionally, SWPAO listed NPC revenue for June 2007 of $2,911,464, while SAP recorded $2,930,981. The PALPOC has subsequently been updated to include the changes in NPC revenues.

When reviewing the PALPOC to SAP reconciliation, we noted that the variable transmission costs per attachment B to the PALPOC were $27 million, while the amount in SAP and Table 5 was $30 million. We inquired as to whether the PALPOC had been updated to reflect the amount in SAP and Table 5. We determined that the figures were updated in the September 29, 2008, version of the PALPOC to $29 million. We obtained the October 31, 2008, version of Table 5, noting that it also reflected the updated amount of $29 million.

Costs of $804 thousand related to 2008 were incorrectly included in the 2007 PALPOC. **We recommend that the Department follow accrual basis accounting when preparing the PALPOCs and FALPOCs**.

Based on the revised 1998 FALPOC issued July 26, 2006, the actual power costs for 1998 were understated by $1.6 million. The adjustment was initially planned to be included in the 2008 SOC, however, was not included in the 2008 or 2009 SOCs. The Department now plans to include these charges in the December re-bill of the 2009 SOC. **We recommend the Department bill for additional costs in a timely manner**.

OTHER ITEMS

In addition to the items discussed in this executive summary and other areas of this report, the following items relate to findings contained in prior years' reports that we believe continue to warrant the attention of the Contractors.

- Cash flow issues at the Department: Although the Department has not experienced any cash flow issues in recent months, we do not believe they have adequately identified and fixed the underlying issues that caused serious prior cash flow challenges. Furthermore, the Department has not reported the findings of the investigation to the Contractors.

- Due to Contract limitations, the Department is still not able to capitalize SAP and other IT implementation costs.

- Gas hedging account: The Contractors should continue to obtain updates to the gas hedging account and consider alternatives to the current program.

- Funding of joint use facilities: The Contractors should ensure the Department remains current on billing and collecting for the joint use facilities' and Suisun Marsh costs in a timely manner.

- Water Resources Revolving Fund (WRRF): The Contractors should stay apprised of the status of the WRRF reconciliation to ensure it is being done monthly and any write-offs or other adjustment are made.

- Eleven and a half million due from the Department of Finance (DOF): The Contractors should ensure the Department is continuing to follow-up on the ultimate collection of this amount.

- General fund obligations: The State currently owes the Department more than $150 million related to Davis-Dolwig and Suisun Marsh obligations.

- Capitalization of costs that meet the Betterment Criteria, including costs related to the California Aqueduct.

- Department Staffing: According to the Vacancy Report dated December 11, 2008, there are a total of 199 vacant positions at the Department. This is an increase of 117 positions from the November 8, 2007, report. The lack of qualified staff significantly contributes to many of the problems identified in this report.

SECTION 2

POTENTIAL PROTEST LETTER ITEMS

The items listed in this section are potential protest letter items identified as of the date of this report. Although we recognize that all of the items on this list may not be advantageous for certain Contractors to file, we have included items that we feel may be of importance to you. In addition to these items, **we recommend you read the entire EY report to determine if there are other items that you consider to be a protest item for your agency**.

Accuracy of the Statement of Charges and B-Tables

- The 2009 SOC tested by EY and the supporting B-Tables contained numerous errors or required significant effort to test. This is due to the fact that most of the processes performed to prepare the SOCs are manual offline processes that have been implemented to account for transactions such as permanent transfers. **We recommend that the Department automate these processes**. This will provide greater accuracy in the SOCs as well as decrease the time necessary to prepare them.

Delta Habitat Conservation and Conveyance Program Costs

- Two invoices from HDR, Inc., (invoices #44255 and #53418 totaling $459 thousand) had notation that they related to BDCP and DHCCP. It was not clear that these costs were solely related to DHCCP from the invoice. The Department indicated that BDCP is covered under DHCCP. We were unable to obtain evidence to support this assertion prior to the date of this report.

Springing Amendment Calculation

- The Department performed the calculation of the amount being released by the springing amendment based on information prior to the issuance of series AE. **We recommend the Department update the calculation to include all bond series issued and payments made to date**. By including Series AE and reflecting the 2008 debt service payments in the calculation, we believe that the

Department could free up an additional $5 million in debt service reserves that could be distributed to the Contractors.

Overhead Allocation

- We were unable to get a response from the Department as to whether any costs related to the FloodSafe program were being included in the staff benefits, POE, or LM overhead categories. We do not believe these costs should be treated as overhead as they do not benefit the SWP as a whole.

Debt Service Allocation

- The Department was unable to show EY where the bond issuance costs and underwriter's discount (totaling $3.5 million for series AE) were included in the debt service schedule dated October 1, 2008. As of the date of this report, we were unable to determine if these costs were included. As a result, we were unable to determine the impact to the Contractors.

Rate Management Credit Calculation

- There is no formal documentation of the process for preparation of the RMC calculation, which we believe could result in inconsistencies and inaccuracies within the calculation.

- There were numerous items that we tested within the RMC calculation that were not supportable by the Department or were incorrect in the calculation.

Off-Aqueduct Power Facilities

- The Department does not estimate power revenues in the initial or May allocation of OAP facilities charges.

- Under the Department's current process for OAP, the shortest time lag between the end of a billing period and the issuance of refund notices or additional billings is two years. The refunds or billings resulting from the final true-up of costs do not occur until three years subsequent to the end of a billing period (for example, the billing related to the 2006 final year-end allocation will not occur until 2009).

There is currently an under-billing related to 2006 of $1.2 million and a refund related to 2007 of $29.3 million that have not been settled with the Contractors. **We recommend the Department reduce this lag to provide a timely settlement with the Contractors**.

- An additional $1.6 million was included in the Reid Gardner O&M costs within the 2007 preliminary year-end allocation in anticipation of future invoices. We obtained a breakdown of the $1.6 million and noted that there was no support for $500 thousand of the costs. We **recommend that the Department refrain from including unsupported cost estimates in the preliminary year-end allocation as the allocation is prepared numerous months after the end of the previous calendar year (i.e., the 2007 preliminary year-end allocation was finalized in August 2008) and should no longer rely on unsupported estimates**.

- Costs related to 2008 of approximately $366 thousand were incorrectly included in the preliminary year-end allocation of 2007 OAP facilities charges.

Delta Water Rate

- The capital component included manual additions of $200 million related to the costs to implement an amendment to the Four Pumps Agreement, which is to further mitigate fish loss at the Delta Pumping Plant. The minimum component included manual additions of $128 million related to the future cost estimates for the DHCCP. There is no support for the cost estimates currently being included. The Department has indicated that it will remove the DHCCP costs from the DWC in the December re-bill.

- The Department was not able to provide adequately detailed explanations for all of the changes in the SAP data pulled for Table B-13 between the current year and the prior year. The Department should be able to support all changes and provide explanation for significant current year fluctuations.

- The Table A entitlement water within the “Entitlement Water Present Worth to 2008” schedule differed from Bulletin 132-08, Table B-4 by 9,900 acre feet. We determined that this difference does not have a significant monetary impact (less than $10 thousand on the total present worth); however, the two schedules should be in agreement.

- The Department's current methodology of computing the DWC fails to acknowledge that Contractors make semi-annual and monthly minimum payments and, therefore, deprives them of any related interest benefits.

Transportation Charges

- The transportation variable charge per the SOC Attachment 4C for two of the three Contractors selected for testing did not appear to be calculated correctly in the SOC. The Department has indicated that it will correct this in the December 2008 re-bill.

- We were unable to recalculate the transportation variable costs per Table B-12 for the reaches selected using SAP for all three of our selections in the current year. The Department has indicated that it will recalculate the Table B-12 costs using SAP for the December 2008 re-bill.

- We were unable to recalculate the 2007 unit rate per Bulletin 132-08, Table B-17 for the Mojave Siphon Powerplant using Bulletin 132-08, Table B-6 and Table B-12, as in amount in Table B-6 is incorrect. The Department has indicated that this will be trued-up in Bulletin 132-09.

Monterey Amendment

- As of December 2008, the Department had not finalized the amount of the 2009 RMCs.

- The 2005 and 2006 RMC allocations were prepared using the incorrect B-Tables.

Water System Revenue Bond Surcharge

- The WSRB surcharge for the 2009 SOC was calculated using estimated values for series AE, which resulted in a misstatement of the WSRB surcharge. The Department has indicated that it will update these amounts to the actual figures in the December 2008 re-bill. Our calculation, based on October 2008 data obtained from the Department, projects an overall decrease to the WSRB surcharge of approximately $1.4 million.

Statement of Charges

- We identified seven instances (two each from Kern County Water Agency – M&I, Kern County Water Agency – Ag and Santa Barbara County Flood Control and Water Conservation District and one from Mojave Water Agency) in which the "Annual Quantities Delivered or Requested" per Attachment 4C did not agree to Bulletin 132-08, Table B-5B. However, we noted the correct deliveries were used in calculating the calculated components.

- We identified seven instances (one from Mojave Water Agency, one from Alameda County Water District and five from Kern County Water Agency – Ag) where the "Annual Quantities Delivered or Requested" did not agree to Bulletin 132-08, Table B-5B (which does not take water credits into account). These amounts did agree to an offline schedule showing annual quantities with water credits.

- Eighteen of the 30 calculated component amounts we selected for testing from Attachment 4C did not agree to SAP.

- The payments received for 2003 and 2004 per Mojave Water Agency's Attachment 4E changed from the prior year SOC. We were unable to obtain an explanation of these variances from the Department.

- The Department did not use the most current B-Tables in the 2008 allocation of BDCP charges.

- MWQI charges were added to the 2008 and 2009 SAP minimum component totals manually. However, these charges, totaling $3.1 million in 2008 and $3 million in 2009, had previously been entered into SAP and were thus being included twice in the minimum component. The Department has indicated that it will correct this in the re-bill.

Internal Audit

- Through our review of the Internal Audit report on internal controls, we noted weaknesses in the Department's cash receipts, revolving fund, cash disbursements, receivables, purchases, fixed assets, financial statement and personnel processes, which could affect the accuracy of the Contractors' bills.

- Through our review of the Internal Audit report on the UNIX server security, we noted that the Department does not appear to have proper security controls in place over who has access to the server, which could affect the accuracy of the Contractors' bills.

Replacement Accounting System

- In the current year, the Department expressed that there had been changes to the PAYGO process. However, it did not comply with our request for information regarding the nature of these changes.

- The meeting to assess the reserve balance was intended to occur annually beginning in 2001; however, this meeting has not taken place in recent years.

- The acre-feet quantity in the water through plant allocation did not agree to Bulletin 132-08, Table B-5B for three out of five of the Contractors selected. This inaccuracy was due to a processing error in SAP. As the bills are generated by amounts pulled from SAP, this issue raises questions as to the accuracy of other amounts pulled from this system. The Department has indicated that it will correct the allocation in the December re-bill.

- The rotating rate was incorrectly used to calculate the replacement cost of stationary equipment at the Chrisman plant. Although this did not have a large impact to any one Contractor (the largest impact was $1,047), the Department should implement sufficient controls to catch this type of error.

- Replacement charges in Attachment 5 of the SOC were reversed for Alameda County Flood Control & Water Conservation District Zone 7 and Alameda County Water District, and Kern County Water Agency – Ag and Kern County

Water Agency – M&I. The Department has indicated that it will correct these errors in the December re-bill.

- The conservation fund does not accurately reflect the $5 million that was collected to replenish it. We recommend that the Department work to properly account for the conservation fund as soon as possible and reevaluate the need for the fund.

System Power Costs

- The 1999-2007 FALPOCs have not been completed.

- A distribution of $121,161 from the Enron bankruptcy settlement was excluded from the current version of the 2000 FALPOC.

- Costs of $804 thousand related to 2008 were incorrectly included in the 2007 PALPOC.

Other Miscellaneous Items

- The Department has incurred costs at Gorman Creek that we believe should be capitalized. However, the Department has treated these costs as O&M.

- The State has continued to refuse to pay its obligations under the Davis-Dolwig Act, the Suisun Marsh agreements and other legislative actions. This results in less cash at the Department, which has contributed to the cash flow issues at the Department and has also resulted in less cash available to fund RMCs for the Contractors.

- The Department has improperly included charges as replacements in the 2004 and 2005 SOCs related to Edmonston Pumping Plant, Banks Pumping Plant, Pear Blossom Pumping Plant and OSO Pumping Plant.

SECTION 3

DETAILED DISCUSSION OF THE 2008 SPECIAL PROCEDURES

Section 3 of our report contains a detailed discussion of our results from the special procedures requested by the IAA that EY performed during 2008.

DELTA HABITAT CONSERVATION AND CONVEYANCE PROGRAM COSTS

General Background

The Department has begun expending money on the initial planning costs for the DHCCP. Discussions among the Department, USBR, Central Valley Project (CVP) Contractors and SWC are ongoing as to how this project will be funded and repaid. Current negotiations indicate 50% of costs will be paid by CVP Contractors and 50% of costs will be paid by SWC. Additionally, the Department and the SWC are in negotiations to implement a new agreement, under which, the SWC will fund the difference between the revenues collected under the DWC for the initial planning costs and the actual costs incurred to ensure that there is no negative impact to the cash flow of the SWP.

Procedures Requested

- Ensure the Department has set up a separate project for tracking the DHCCP initial planning and design costs.
- Test costs on a sample basis to determine proper coding to DHCCP.
- Determine that the Department has internal documentation in place supporting the funds collected from the SWC and expenditures against those funds.
- Ensure consistency on the policies and procedures used by the Department for the project with the funding agreement between the Department and SWC.

Procedures Performed

- We obtained the fund centers in place to track DHCCP costs from the division chief of the DOE and obtained the historical cost information through November 30, 2008, by month.

- We selected all costs greater than $10 thousand from the detail to verify that the classification within the DHCCP cost center was reasonable based on the description. We also selected the six largest vendor invoices from the three consultants being utilized and obtained invoices to verify that they related to DHCCP.

- We obtained copies of the contracts in place with the external consultants in order to determine the total amount the Department is currently committed to spend related to DHCCP.

- We met with the project manager within DOE and discussed the status of the DHCCP project to date.

Findings and Results

1) We verified that the Department has set up fund centers to appropriately capture all costs incurred related to DHCCP. We pulled the monthly totals from SAP for these projects, noting the following amounts had been expended. (Note that these amounts are cumulative totals and represent the amounts recorded under the DHCCP fund centers at a specific point in time).

Month	Total DHCCP Spent to Date (Cumulative)
April 30, 2008	$ 6,160
May 31, 2008	112,713
June 30, 2008	1,270,025
July 31, 2008	1,553,142
August 31, 2008	1,716,147
September 30, 2008	2,513,796
October 31, 2008	4,048,003
November 30, 2008	4,761,587

Discussions at the November 4, 2008, Audit-Finance Committee meeting indicated that the Department is currently estimating a total of $8 million to be paid out by December 31, 2008. The plan is to include 50% of this projected spending (the SWC portion under the assumed 50% split with the USBR) in the December 2008 re-bill of the 2009 SOC. **Based on the spending history shown above, it does not appear that $8 million will be spent by December 31, 2008.** Our discussions with DOE indicated that they expected the total spend to be between $6 million and $10 million by the end of the year.

2) Upon reviewing the detail of the amounts spent to date in SAP, we noted that the following external consultants are currently being used by the Department:

- HDR, Inc. – HDR is an employee-owned architectural, engineering and consulting firm that helps clients manage complex projects.

- URS Corporation – URS is a publicly owned company that provides a range of planning, engineering and architectural design, environmental, construction, program and construction management, systems integration, operations and maintenance and management services.

- CH2M Hill – CH2M Hill is an employee-owned full-service engineering, consulting, construction and operations firm.

We obtained the description for all costs greater than $10 thousand from SAP in order to test the classification as DHCCP costs. Costs greater than $10 thousand as of October 31, 2008, represented $2.5 million of the $4 million spent to date, or 63%. Of the amounts over $10 thousand, $1.2 million was paid to URS, $459 thousand was paid to HDR, Inc. and $437 thousand was paid to CH2M Hill. The remaining $362 thousand related to various overhead allocations.

We selected six invoices from the SAP detail totaling $1.7 million for testing. We reviewed copies of these invoices, noting that four out of the six were clearly related to DHCCP. The other two invoices, both from HDR, Inc. (invoices #44255 and #53418 totaling $459 thousand) had notation that they related to the BDCP and DHCCP. Through inquiry of the Department, we determined these costs were related to writing an EIR. **It was not clear that these costs were solely related to DHCCP from the**

invoice. The Department indicated that BDCP is covered under DHCCP. We were unable to obtain evidence to support this assertion prior to the date of this report.

3) **We obtained copies of the contracts with the external consultants mentioned above, noting that there are currently total commitments of $93 million.** The breakdown is as follows: The contract with HDR Inc. is for $25 million and the term is from June 12, 2008, to December 13, 2015; the contract with URS Corporation is for $60 million and the term is May 27, 2008, to December 31, 2015; and the contract with CH2M Hill is for $8 million and the term is from July 1, 2006, to June 30, 2009.

4) At this point, no funds have been collected from the Contractors to fund the DHCCP costs. The Department plans to withhold $13 million of the Springing Amendment funds to cover the 2008 DHCCP costs in the interim. **As no funds have been collected from the Contractors by the Department, we were unable to determine if appropriate measures are being taken to segregate funding for DHCCP from other projects.** The July 1, 2008, version of the 2009 SOC includes $128 million in costs for DHCCP in the DWC minimum ($24 million in 2009, $49 million in 2010, and $55 million in 2011). The Department has indicated that it will remove these costs in the December re-bill of the 2009 SOC, which is expected to reduce the DWC by $1.90 per acre foot. The Department will then have a separate line included under the transportation minimum to collect the funds from those Contractors who have signed the funding agreement. A funding agreement is currently being negotiated. **As a funding agreement was not finalized during our current year procedures, we have not performed any testing in this area.**

SPRINGING AMENDMENT CALCULATION

General Background

In 2008, the Department determined that it achieved the required threshold to implement the revenue bond springing amendment. This amendment enables the Department to reduce the dollar amount of the revenue bond reserve. In previous discussions with the Department, it was indicated that approximately $77 million (ultimately, the amount calculated was only $72 million) would be released from the revenue bond reserve fund and that these funds would be used to offset the capital payments from the Contractors and/or to pay for ongoing projects.

Prior to the springing amendment, the reserve account requirement, for any date of the calculation, was to be the sum, for all series of bonds outstanding, for which interest is then in whole or part payable from revenues, of the lesser, for each such series of bonds, of (1) the amount of one year's interest on such series when originally issued, or (2) the maximum annual debt service for the then current year or any year after such date of the calculation on the then outstanding bonds of such series.

Subsequent to the effective date of the springing amendment, instead of the method previously used to determine the debt service reserve requirement, the new provision would require the fund to contain "an amount equal to one-half of the maximum annual debt service in the current or any following fiscal year on all outstanding bonds." This requirement was to go into effect when the Department obtained the consent of the owners of at least 60% of the principal amount of the bonds outstanding. Through discussions with the Department, we determined that the Department reached the 60% consent requirement following the principal payment that was made on December 1, 2007. Under the bond resolution, prior to enforcing the springing amendment, the Department was required to notify all bond-holders of the change. This notification, and thus the effective date of the springing amendment, was dated January 18, 2008.

<u>Procedures Requested</u>

- Obtain the Department's calculation of the required revenue bond reserve fund balance (the "fund balance") per the springing amendment and bond indentures. Verify that the calculated required fund balance and resultant amount of funds to be released from implementing the springing amendment are properly calculated.

- Obtain the Department's allocation to the Contractors of the released reserve funds and perform procedures to determine the clerical accuracy of the allocation, as well as testing a sample of the inputs on the schedule. Document the methodology used to allocate the released reserve funds.

- Ensure that the Department's calculated fund balance is consistent with the reserve requirements contained in the revenue bond indentures and springing amendments.

Procedures Performed

- Obtained the Department's calculation supporting the $72 million in funds being released by the springing amendment. Tested the clerical accuracy of the calculation. This calculation was performed as of January 18, 2008, and included all currently outstanding bond series with the exception of the AE series.

- Agreed the pre-amendment debt service reserve requirement to our testing in the prior year, and investigated any differences.

- By series, agreed the maximum annual debt service amounts from the Department's calculation to the October 1, 2007, debt service schedule obtained during our prior year procedures. Investigated any differences. Recalculated the new debt service requirement by dividing these amounts in half.

- Obtained the notification sent to the bond-holders and verified the date was January 18, 2008.

- Obtained the current balance in the debt service reserve fund.

Findings and Results

1) **The Department performed the calculation of the amount being released by the springing amendment based on information prior to the issuance of series AE. We recommend the Department update the calculation to include all bond series issued and payments made to date.** We performed a recalculation of the surplus we would expect to see released from the debt service reserve subsequent to the series AE issuance, using the debt service balance in the debt service reserve fund as of October 31, 2008. We utilized the calculation method outlined in the revenue bond indentures and springing amendment and noted an increase in the surplus of approximately $5 million or 7% to $77 million (the use of updated data, which included series AE and reflected debt service payments made during 2008, resulted in an increase to the surplus).

2) The asset balance in the debt service reserve fund as of October 31, 2008, was $187.8 million. **We recommend the Contractors monitor the amount and nature of the**

surplus that has accumulated in the debt service reserve fund and ensure that excess funds are returned as they become available.

3) The Department's analysis of the actual allocation of bond proceeds to Contractors was not available for our testing as of December 2008. As such, we were unable to test this as part of the current year procedures.

DELTA WATER CHARGE CALCULATION AND ASSUMPTIONS

General Background

The conservation facilities' operating costs shown in Bulletin 132, Table B-13 have increased significantly in the last 10 years. Table B-13 does not provide breakdowns of the total costs assigned to the conservation facilities capital costs and operating costs to provide visibility as to what cost categories are increasing.

Procedures Requested

- Provide a breakdown by year and category of the capital and operating costs used in Bulletin 132, Table B-13.
- Provide data for the last 10 years to establish trends.
- Group costs by reach into categories such as direct salary and wages, overhead, direct pay, studies, consultants and other groupings as data is available.
- Provide categorized data and assumptions by reach used for the 2009 SOC for the time period 2008–2012.

Procedures Performed

- Pulled the capital and operating costs used in Bulletin 132-08, Table B-13 from SAP by year and category (refer to findings and results section below for the detail).
- Obtained explanations for all variances in the amounts pulled from SAP and Bulletin 132-08, Table B-13 greater than $1 million by year.

- For both operating and capital costs, compiled a comparison of the Bulletin 132, Table B-13 data from 1999–2008 (refer to findings and results section below for the detail).

- For changes in operating and capital costs greater than 10% year over year, obtained an explanation for the major contributors to the change.

Findings and Results

1) The following reports show the EY calculated components of the capital and operating costs (these figures have not been adjusted for present value):

Bulletin 132-08 Capital Costs from SAP

CAPITAL COSTS	A	B	C	D	E	F	G	H	I=A+B+C+D+E+F+G+H	J=A+C+D+G	K	L	M=K-J-L
YEAR	Oroville	Oroville Power Revenue	Delta	California Aqueduct & San Luis	Planning & Preoperation	Credits	Additional Conservation Facilities	Contractor Revenue	Total	EV Calculated Capital Costs	Table B-13 Actual Amounts	Incremental Capital Costs (14% to 3.4%)	Difference
1952	$ [illegible]	$	$	$ 4,87[illegible]	$	$	$	$	$ 171,922	$ [illegible]	$ [illegible]	$	$
1953	206,218	–	–	13,972	–	–	–	–	312,190	312,190	312,190	–	–
1954	201,836	–	–	10,758	–	–	–	–	308,624	308,634	308,634	–	–
1955	185,841	–	–	8,304	–	–	–	–	194,145	194,145	194,145	–	–
1956	1,3[illegible],186			25,621					1,357,077	1,357,077	1,357,077		
1957	6,129,283			81,426					6,210,709	6,210,709	6,210,709		
1958	3,378,527	–	3,021	132,369	–	–	–	–	3,510,917	3,510,916	3,510,916	–	–
1959	10,360,207	–	5,911	1,218,369	–	–	–	–	11,590,586	11,590,586	11,590,586	–	–
1960	[illegible]		67,44[illegible]	[illegible]		(4,890,000)			[illegible]	[illegible]	[illegible]	6,919	
1961	[illegible]		211,179	[illegible]		[illegible]			[illegible]	[illegible]	[illegible]	42,429	
1962	6,082,730	–	729,197	2,151,069	–	(420,290)	–	–	8,535,080	9,012,060	9,092,068	57,008	–
1963	46,744,590	–	1,184,[illegible]	25,067,077	–	(478,545)	–	–	[illegible]	72,095,738	[illegible]	[illegible]	–
1964	30,429,374	–	1,301,640	31,778,540	107,780	(751,550)	–	–	61,851,206	[illegible]	[illegible]	[illegible]	–
1965	46,053,339	–	1,490,870	23,050,515	551,850	(733,541)	–	–	70,700,297	70,920,088	71,045,877	125,885	–
1966	[illegible]		842,089	[illegible]	180,079	(718,729)			[illegible]	[illegible]	[illegible]	[illegible]	
1967	[illegible]		827,734	[illegible]	[illegible]	(812,145)		[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	
1968	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	(231,942)		[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	
1969	610,062	[illegible]	1,410,008	3,159,909	[illegible]	[illegible]		[illegible]	[illegible]	[illegible]	[illegible]	57,884	
1970	1,697,811	(4,650,000)	1,150,700	1,281,889	516,030	(206,793)	–	[illegible]	(11,847,954)	4,130,400	4,208,410	77,920	–
1971	[illegible]	(4,650,000)	[illegible]	852,885	408,754	(109,031)	–	[illegible]	(12,578,155)	3,877,409	3,956,[illegible]	[illegible]	–
1972	2,517,[illegible]	(4,650,000)	270,068	705,551	257,374	(190,361)	–	(5,594,558)	(15,584,502)	4,520,024	4,632,255	96,29[illegible]	–
1973	[illegible]	(4,650,000)	[illegible]	900,210	205,384	[illegible]	–	(5,858,429)	(16,499,077)	3,985,[illegible]	4,080,077	104,[illegible]	–
1974	[illegible]	[illegible]	1,377,448	[illegible]	[illegible]	[illegible]		[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	
1975	[illegible]	[illegible]	[illegible]	495,558	146,138	[illegible]		[illegible]	[illegible]	8,284,450	[illegible]	[illegible]	
1976	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]		[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	
1977	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]		[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	
1978	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	(62,966)		[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	
1979	[illegible]	[illegible]	[illegible]	258,994	3,131,884			[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	
1980	577,700	(14,650,000)	9,322,[illegible]	372,898	5,023,85[illegible]	–	–	(19,585,564)	[illegible]	10,372,755	[illegible]	972,8[illegible]	–
1981	[illegible]	(14,650,000)	[illegible]	[illegible]	[illegible]	–	–	[illegible]	(33,411,045)	[illegible]	[illegible]	[illegible]	–
1982	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]			[illegible]	[illegible]	[illegible]	[illegible]	844,[illegible]	
1983	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]			[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	

Bulletin 132-08 Capital Costs from SAP (continued)

CAPITAL COSTS	A	B	C	D	E	F	G	H	I=A+B+C+D+E+F+G+H	J=A+C+D+E+G	K	L	M=K-J-L
YEAR	Oroville	Oroville Power Revenue	Delta	California Aqueduct & San Luis	Planning & Preoperation	Credits	Additional Conservation Facilities	Contractor Revenue	Total	EV Calculated Capital Costs	Table B-13 Actual Amounts	Incremental Capital Costs (14% to 3.4%)	Difference
1984	$ [illegible]	$ (14,650,000)	$ [illegible]	$ [illegible]	$ [illegible]	$	$	$ [illegible]	$ [illegible]	$ [illegible]	$ [illegible]	$ [illegible]	$
1985	[illegible]	(14,650,000)	[illegible]	[illegible]	[illegible]			[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	
1986	[illegible]	(14,650,000)	[illegible]	722,098	[illegible]	–	–	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	–
1987	4,618,000	(14,650,000)	19,924,027	7,251,259	1,702,179	–	–	(26,277,374)	[illegible]	50,814,256	32,754,639	1,020,367	–
1988	[illegible]	(14,650,000)	[illegible]	[illegible]	[illegible]			[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	
1989	[illegible]	(14,650,000)	[illegible]	[illegible]	[illegible]			[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	
1990	[illegible]	(14,650,000)	[illegible]	[illegible]	[illegible]			[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	
1991	[illegible]	(14,650,000)	[illegible]	[illegible]	[illegible]			[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	( )
1992	[illegible]	(14,650,000)	[illegible]	[illegible]	[illegible]			[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	
1993	[illegible]	(14,650,000)	[illegible]	[illegible]	[illegible]			[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	
1994	1,300,204	(14,650,000)	[illegible]	592,502	2,154,512	–	–	[illegible]	[illegible]	3,765,771	[illegible]	[illegible]	–
1995	973,870	(14,650,000)	[illegible]	1,079,571	[illegible]	–	–	[illegible]	[illegible]	4,295,704	[illegible]	[illegible]	–
1996	[illegible]	(14,650,000)	8,791,588	[illegible]	[illegible]	–	953,148	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	–
1997	1,048,929	(14,650,000)	10,505,539	1,809,402	1,023,730	–	[illegible]	[illegible]	[illegible]	[illegible]	5,304,535	[illegible]	
1998	[illegible]	(14,650,000)	[illegible]	[illegible]	[illegible]		[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	
1999	[illegible]	(14,650,000)	[illegible]	[illegible]	[illegible]		[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	1
2000	[illegible]	(14,650,000)	[illegible]	[illegible]	[illegible]		[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	
2001	[illegible]	(14,650,000)	[illegible]	[illegible]	[illegible]		[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
2002	[illegible]	(14,650,000)	2,887,029	452,038	[illegible]	–	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	–
2003	[illegible]	(14,650,000)	[illegible]	175,789	[illegible]	–	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	( )
2004	184,755	(14,650,000)	[illegible]	[illegible]	3,548	–	935,482	[illegible]	[illegible]	[illegible]	15,784,079	[illegible]	–
2005	[illegible]	(14,650,000)	(7,772,590)	[illegible]	-	–	[illegible]	(48,070,851)	[illegible]	[illegible]	(6,159,718)	[illegible]	–
2006	[illegible]	(14,650,000)	[illegible]	[illegible]			[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
2007	[illegible]	(14,650,000)	[illegible]	[illegible]			[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	( )
2008	[illegible]	(14,650,000)	[illegible]	[illegible]			[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	
2009	[illegible]	[illegible]	[illegible]	[illegible]			[illegible]		[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
2010	[illegible]	[illegible]	[illegible]	[illegible]			[illegible]		[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
2011	[illegible]	[illegible]	[illegible]	[illegible]			[illegible]		[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
2012	1,302,504	[illegible]	[illegible]	759,050	–	–	[illegible]	–	[illegible]	5,426,200	[illegible]	904,429	20,000,000
2013	[illegible]	[illegible]	[illegible]	[illegible]	–	–	[illegible]	–	[illegible]	[illegible]	[illegible]	146,701	20,000,000
2014		[illegible]					[illegible]		[illegible]	[illegible]	[illegible]		[illegible]
2015		[illegible]					[illegible]		[illegible]	[illegible]	[illegible]		[illegible]
2016		[illegible]					[illegible]		[illegible]	[illegible]	[illegible]		[illegible]

Bulletin 132-08 Capital Costs from SAP (continued)

CAPITAL COSTS	A	B	C	D	E	F	G	H	I=A+B+C+D+E+F+G+H	J=A+C+D+G	K	L	M=K-J-L
YEAR	Oroville	Oroville Power Revenues	Delta	California Aqueduct & San Luis	Planning & Preoperation	Credits	Additional Conservation Facilities	Contractor Revenues	Total	DWR Calculated Capital Costs	Table B-13 Actual Amounts	Incremental Capital Costs (14% to 3.4%)	Difference
2017	$	$ [illegible]	$	$	$	$	$ [illegible]	$	$ [illegible]	$ [illegible]	$ [illegible]	$	$ 20,000,000
2018		[illegible]					[illegible]		[illegible]	[illegible]	[illegible]		20,000,000
2019	-	(16,259,000)	-	-	-	-	997,903	-	(5,655,157)	997,903	997,903	-	-
2020	-	(16,259,000)	-	-	-	-	997,903	-	(5,655,157)	997,903	997,903	-	-
2021		[illegible]					[illegible]		[illegible]	[illegible]	[illegible]		
2022		[illegible]					[illegible]		[illegible]	[illegible]	[illegible]		
2023		[illegible]					[illegible]		[illegible]	[illegible]	[illegible]		
2024		[illegible]					[illegible]		[illegible]	[illegible]	[illegible]		
2025		[illegible]					[illegible]		[illegible]	[illegible]	[illegible]		
2026		[illegible]					[illegible]		[illegible]	[illegible]	[illegible]		
2027	-	(16,259,000)	-	-	-	-	997,903	-	(5,655,157)	997,903	997,903	-	-
2028	-	(16,259,000)	-	-	-	-	997,903	-	(5,655,157)	997,903	997,903	-	-
2029	-	(16,259,000)	-	-	-	-	997,903	-	(5,655,157)	997,903	997,903	-	-
2030	-	(14,250,000)	-	-	-	-	997,903	-	(4,252,097)	997,903	997,903	-	-
2031		[illegible]					[illegible]		[illegible]	[illegible]	[illegible]		
2032		[illegible]					[illegible]		[illegible]	[illegible]	[illegible]		
2033		[illegible]					[illegible]		[illegible]	[illegible]	[illegible]		
2034		[illegible]					[illegible]		[illegible]	[illegible]	[illegible]		
2035	-	[illegible]	-	-	-	-	997,903	-	[illegible]	997,903	997,903	-	-
	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]

Source: SAP for historical years; [illegible] for future years

We investigated differences by year between our calculation of the capital costs and the capital costs per Table B-13 greater than $1 million dollars. Per discussions with the Department, we determined that the $20 million dollar differences from 2009 to 2018 (totaling $200 million for all years affected) resulted from the costs to implement the Four Pumps Agreement to mitigate fish loss at the Delta Pumping Plant. See Delta Water Rate discussion under our regular procedures for additional discussion and resulting recommendations.

Bulletin 132-08 Minimum Costs from SAP

OPERATING COSTS	A	B	C	D	E	F	G	H	I=A+B+C+D+E+F+G+H	J=A+C+D+G	K	L	M=K-J
YEAR	Oroville	Oroville Power Revenues	Delta	California Aqueduct & San Luis	Planning & Preoperation	Credits	Additional Conservation Facilities	Contractor Revenues	Total	EV Calculated Operating Costs	Table B-13 Actual Amounts	Incremental Minimum Costs (14% to 3.4%)	Difference
1963	$	$	$ (14,000)	$	$	$	$	$	$ (14,000)	$ (14,000)	$ (14,000)	$	$
1964			(14,000)						(14,000)	(14,000)	(14,000)		
1965			(14,000)						(14,000)	(14,000)	(14,000)		
1966			(14,000)						(14,000)	(14,000)	(14,000)		
1967	554	–	(14,000)	–	–	–	–	–	(13,446)	(13,446)	(13,446)	–	–
1968	[illegible]	–	(10,570)	1,257,191	–	–	–	–	1,305,821	1,305,821	1,305,821	–	–
1969	1,552,432	–	[illegible]	357,840	–	–	–	–	2,890,772	2,890,772	2,890,772	–	–
1970	[illegible]	(1,500,000)	[illegible]	180,971	–	–	–	(513,510)	[illegible]	[illegible]	[illegible]	–	–
1971	[illegible]	(1,500,000)	[illegible]	[illegible]				[illegible]	[illegible]	[illegible]	[illegible]		
1972	[illegible]	(1,500,000)	81,882	[illegible]				[illegible]	[illegible]	[illegible]	[illegible]		
1973	[illegible]	(1,500,000)	354,[illegible]	[illegible]				[illegible]	[illegible]	[illegible]	[illegible]		
1974	[illegible]	(1,500,000)	[illegible]	[illegible]				[illegible]	[illegible]	[illegible]	[illegible]		
1975	[illegible]	[illegible]	[illegible]	[illegible]				[illegible]	[illegible]	[illegible]	[illegible]		
1976	[illegible]	[illegible]	[illegible]	[illegible]				[illegible]	[illegible]	[illegible]	[illegible]		
1977	7,480,145	(1,500,000)	[illegible]	[illegible]	–	–	–	[illegible]	[illegible]	[illegible]	[illegible]	–	–
1978	7,486,502	(1,500,000)	[illegible]	[illegible]	–	–	–	[illegible]	7,232,114	[illegible]	[illegible]	–	–
1979	[illegible]	(1,500,000)	[illegible]	[illegible]				[illegible]	[illegible]	[illegible]	[illegible]		
1980	[illegible]	[illegible]	[illegible]	[illegible]				[illegible]	[illegible]	[illegible]	[illegible]		
1981	[illegible]	[illegible]	[illegible]	[illegible]				[illegible]	[illegible]	[illegible]	[illegible]		
1982	[illegible]	[illegible]	[illegible]	[illegible]				[illegible]	[illegible]	[illegible]	[illegible]		
1983	[illegible]	[illegible]	[illegible]	[illegible]				[illegible]	[illegible]	[illegible]	[illegible]		
1984	[illegible]	[illegible]	[illegible]	[illegible]				[illegible]	[illegible]	[illegible]	[illegible]		
1985	[illegible]	(8,198,000)	[illegible]	[illegible]	–	–	–	[illegible]	[illegible]	[illegible]	[illegible]	–	–
1986	[illegible]	(9,107,000)	[illegible]	[illegible]	–	–	–	(23,109,410)	[illegible]	25,479,379	25,479,379	–	–
1987	[illegible]	[illegible]	[illegible]	[illegible]				[illegible]	[illegible]	[illegible]	[illegible]		
1988	[illegible]	[illegible]	4,446,[illegible]	[illegible]				[illegible]	[illegible]	[illegible]	[illegible]		
1989	[illegible]	[illegible]	[illegible]	[illegible]				[illegible]	[illegible]	[illegible]	[illegible]		
1990	[illegible]	(8,298,000)	14,[illegible]	[illegible]				[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	
1991	[illegible]	[illegible]	[illegible]	8,4[illegible]				[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	
1992	[illegible]	[illegible]	[illegible]	[illegible]				[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	
1993	18,0[illegible]	(8,768,000)	10,120,307	7,232,900	–	–	–	(34,458,290)	[illegible]	[illegible]	[illegible]	[illegible]	–
1994	[illegible]	(7,484,000)	14,[illegible]	[illegible]	–	–	–	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	–
1995	[illegible]	[illegible]	14,875,103	[illegible]	–	–	–	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	–

Bulletin 132-08 Minimum Costs from SAP (continued)

OPERATING COSTS	A	B	C	D	E	F	G	H	[illegible]	[illegible]	K	L	[illegible]
YEAR	Oroville	Oroville Power Revenues	Delta	California Aqueduct & San Luis	Planning & Preparation	Credits	Additional Conservation Facilities	Contractor Revenues	Total	EV Calculated Operating Costs	Table B-13 Actual Amounts	Incremental Minimum Costs (14% to 3.4%)	Difference
1996	$ [illegible]	$ [illegible]	$ [illegible]	$ [illegible]	$	$	$ [illegible]	$ [illegible]	$ [illegible]	$ [illegible]	$ [illegible]	$ [illegible]	$
1997	[illegible]	[illegible]	[illegible]	[illegible]			[illegible]	[illegible]	(2,655,308)	[illegible]	[illegible]	[illegible]	
1998	[illegible]	[illegible]	[illegible]	[illegible]			[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	
1999	[illegible]	[illegible]	[illegible]	[illegible]			[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
2000	[illegible]	(10,452,209)	[illegible]	1,078,182	–	–	[illegible]	[illegible]	(5,553,875)	53,091,541	[illegible]	1,367,411	[illegible]
2001	[illegible]	(15,151,493)	[illegible]	23,044,157	–	–	[illegible]	[illegible]	[illegible]	[illegible]	76,148,735	1,576,149	[illegible]
2002	32,386,309	(22,034,770)	[illegible]	16,063,326	–	–	305,278	(52,758,615)	[illegible]	67,114,481	68,440,271	[illegible]	21,403
2003	[illegible]	[illegible]	[illegible]	[illegible]	–	–	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
2004	[illegible]	[illegible]	[illegible]	[illegible]			[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
2005	[illegible]	[illegible]	[illegible]	[illegible]			[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
2006	[illegible]		[illegible]	[illegible]				[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
2007	[illegible]	[illegible]	[illegible]	[illegible]			[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
2008	[illegible]	[illegible]	[illegible]	[illegible]			[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	34,000,000
2009	[illegible]	[illegible]	[illegible]	[illegible]			[illegible]		[illegible]	[illegible]	[illegible]	[illegible]	29,000,000
2010	[illegible]	(15,136,407)	[illegible]	[illegible]	–	–	[illegible]	–	[illegible]	111,807,287	[illegible]	3,080,061	45,000,000
2011	[illegible]	(9,340,000)	20,778,763	17,451,205	–	–	551,803	–	62,795,045	71,335,045	[illegible]	1,150,141	–
2012	[illegible]	[illegible]	[illegible]	[illegible]			[illegible]		[illegible]	[illegible]	[illegible]	[illegible]	
2013	[illegible]	[illegible]	[illegible]	[illegible]			[illegible]		[illegible]	[illegible]	[illegible]	[illegible]	
2014	[illegible]	[illegible]	[illegible]	[illegible]			[illegible]		[illegible]	[illegible]	[illegible]	[illegible]	
2015	[illegible]	[illegible]	[illegible]	[illegible]			[illegible]		[illegible]	[illegible]	[illegible]	[illegible]	
2016	[illegible]	[illegible]	[illegible]	[illegible]			[illegible]		[illegible]	[illegible]	[illegible]	[illegible]	
2017	[illegible]	[illegible]	[illegible]	[illegible]			[illegible]		[illegible]	[illegible]	[illegible]	[illegible]	
2018	[illegible]	(9,340,000)	16,778,763	[illegible]	–	–	[illegible]	–	[illegible]	[illegible]	[illegible]	[illegible]	–
2019	[illegible]	(9,340,000)	16,778,763	[illegible]	–	–	532,457	–	53,121,730	[illegible]	63,774,658	[illegible]	–
2020	[illegible]	[illegible]	[illegible]	[illegible]			[illegible]		[illegible]	[illegible]	[illegible]	[illegible]	
2021	[illegible]	[illegible]	[illegible]	[illegible]			[illegible]		[illegible]	[illegible]	[illegible]	[illegible]	
2022	[illegible]	[illegible]	[illegible]	[illegible]			[illegible]		[illegible]	[illegible]	[illegible]	[illegible]	
2023	[illegible]	[illegible]	[illegible]	[illegible]			[illegible]		[illegible]	[illegible]	[illegible]	[illegible]	
2024	[illegible]	[illegible]	[illegible]	[illegible]			[illegible]		[illegible]	[illegible]	[illegible]	[illegible]	
2025	[illegible]	[illegible]	[illegible]	[illegible]			[illegible]		[illegible]	[illegible]	[illegible]	[illegible]	
2026	[illegible]	(9,340,000)	16,778,763	18,750,521	–	–	532,520	–	54,129,220	[illegible]	64,748,920	870,702	–
2027	[illegible]	(9,340,000)	16,778,763	[illegible]	–	–	539,715	–	50,400,423	[illegible]	[illegible]	870,702	–

Bulletin 132-08 Minimum Costs from SAP (continued)

OPERATING COSTS	A	B	C	D	E	F	G	H	I=A+B+C+D+E+F+G+H	J=A+C+D+G	K	L	M=K-J
YEAR	Oroville	Oroville Power Revenues	Delta	California Aqueduct & San Luis	Planning & Preparation	Credits	Additional Conservation Facilities	Contractor Revenues	Total	EV Calculated Operating Costs	Table B-13 Actual Amounts	Incremental Minimum Costs (14% to 3.4%)	Difference
2028	$ [illegible]	$ (9,040,000)	$ [illegible]	$ [illegible]	$	$	$ [illegible]	$	$ [illegible]	$ [illegible]	$ [illegible]	$ [illegible]	$
2029	[illegible]	(9,040,000)	16,778,756	[illegible]			[illegible]		[illegible]	[illegible]	[illegible]	[illegible]	
2030	[illegible]	(9,040,000)	16,778,756	[illegible]			[illegible]		[illegible]	[illegible]	[illegible]	[illegible]	
2031	[illegible]	(9,040,000)	16,778,756	[illegible]			[illegible]		[illegible]	[illegible]	[illegible]	[illegible]	
2032	[illegible]	(20,040,000)	16,778,756	15,502,834	-	-	[illegible]	-	[illegible]	[illegible]	[illegible]	846,408	-
2033	27,095,030	(20,040,000)	16,778,756	[illegible]	-	-	532,800	-	[illegible]	65,028,725	[illegible]	846,408	-
2034	[illegible]	(20,040,000)	16,778,756	17,501,849	-	-	535,027	-	[illegible]	61,979,085	[illegible]	846,408	-
2035	[illegible]	[illegible]	[illegible]	[illegible]			[illegible]		[illegible]	[illegible]	[illegible]	[illegible]	
	$[illegible]	$[illegible]	$[illegible]	$[illegible]	$	$	$[illegible]	$[illegible]	$[illegible]	$[illegible]	$[illegible]	$[illegible]	$[illegible]

Source: SAP for historical years; [illegible] for future analysis

We investigated differences by year between our calculation of the operating costs and the operating costs per Table B-13 greater than $1 million dollars. As discussed under the DHCCP cost section above, the July 1, 2008, version of the 2009 SOC includes $128 million in costs for DHCCP in the DWC minimum ($24 million in 2009, $49 million in 2010, and $55 million in 2011). The Department has indicated that it will remove these costs in the December re-bill of the 2009 SOC. We also investigated the 2007 difference of $2 million. Per discussion with the Department, this resulted primarily from the manual deduction of $3 million to reflect the BDCP revenue collected in 2007. This is reasonable because the costs are included in the operating component of the DWC, thus the related revenues being collected must be deducted in order to avoid double charging the Contractors.

2) The following table summarizes the total operating and capital costs per Bulletin 132, Table B-13 for the last 10 years:

Bulletin 132-XX	Total Operating Costs Per Table B-13	Increase (Decrease) from the Prior Year	% Change from the Prior Year	Total Capital Costs Per Table B-13	Increase (Decrease) from the Prior Year	% Change from the Prior Year
99	$2,667,492,808	$ (3,182,507)	(0.12%)	$1,052,864,965	$ 868,239	0.08%
00	2,679,230,475	11,737,667	0.44%	1,048,217,130	(4,647,835)	(0.44%)
01	2,722,024,514	42,794,039	1.60%	1,031,669,896	(16,547,234)	(1.58%)
02	2,753,382,670	31,358,156	1.15%	986,384,482	(45,285,414)	(4.39%)
03	2,793,100,623	39,717,953	1.44%	1,001,929,509	15,545,027	1.58%
04	2,816,519,086	23,418,463	0.84%	1,054,089,704	52,160,195	5.21%
05	2,878,130,450	61,611,364	2.19%	1,089,645,257	35,555,553	3.37%
06	2,997,740,079	119,609,629	4.16%	1,095,412,955	5,767,698	0.53%
07	3,094,655,083	96,915,004	3.23%	1,119,024,136	23,611,181	2.16%
08	3,469,705,439	375,050,356	12.12%	1,360,036,639	241,012,503	21.54%

One of the major contributors to the continual increase in operating costs as noted above is that the Department only projects detailed cost data for three years in the future (i.e., the 2009 SOC include projections for 2008–2010 based on an average of expenditures from 2005–2007). When preparing the 2009 SOC utilizing Bulletin 132-08, SWPAO began working toward including more accurate data in the future projections. Through our testing we noted the Department made the following changes in the current year:

- Leveled future costs under the Delta minimum (the Department previously had a step-down effect in future years). Additionally, the Department included a future estimate for extraordinary O&M of approximately $4.5 million per year.

- Increased future costs related to the power costs associated with pumping water into the San Luis Reservoir. The future cost estimates were previously based upon power costs of approximately 15 mills. This was increased to 33 mills to be more consistent with current costs.

The capital costs are developed based on the capital budgets obtained from the DOE. These costs fluctuate depending on what projects obtain approval and the level of funding that they are granted.

The Bulletin 132-08 data also shows a larger variance than other years due to the inclusion of the costs related to the Four Pumps Agreement and the costs related to the DHCCP as previously discussed. **We recommend that the Department and the Contractors continue to analyze the underlying assumptions being used to develop future cost estimates and update them as deemed appropriate. This will prevent large adjustments in the DWC when the estimates are adjusted to actual costs.**

3) We were unable to obtain support in order to group costs by reach into categories, such as direct salary and wages, overhead, direct pay, studies and consultants, as this type of breakdown is not readily available and would require significant Department resources to prepare. We were also unable to obtain categorized data and assumptions by reach used for the 2009 SOC for the time period 2008–2012 for the same reasons. **We strongly recommend that the Department work with the IT group to provide additional visibility into the costs within the DWC through management reports.** We requested a sample from the Department of a breakdown that could be provided to obtain additional visibility over the Delta minimum. We obtained supporting files at the end of November 2008. Due to the complexity of the files and the timing as to when we obtained them, we were unable to analyze or perform any testing on these files.

OVERHEAD ALLOCATION

General Background

Overhead costs are distributed into four main categories. These categories are staff benefits, POE, GM and LM. Other overhead categories are rent and absences.

Staff Benefits

These costs represent employee benefits. Costs related to staff benefits are distributed to all cost centers based on salaries and wages.

Pro-Rated Operating Expenses

These are the costs of services or goods that are of benefit to the Department but cannot be easily attributed to particular programs or organizations. These costs are considered standard costs and are distributed to line staff cost centers based on salaries and wages.

General Management

These costs represent the department-wide management and administrative functions required to oversee the Department's programs and personnel. These costs are distributed to each division based on the historical average of actual GM costs. The costs are then distributed to line staff cost centers based on salaries and wages.

Line Management

These costs represent the supervisory and administrative costs of the Department, as well as certain items of operating expenses attributable to the Department. These costs are distributed to all programs in which the Department's personnel participate. The costs are distributed to non-overhead cost centers in each division.

The final distribution of overhead takes staff benefits, POE, rent, GM, LM and line services costs and sends them to all funded cost objects charged by line staff based on direct labor. Due to the complexity of the Department's programs and processes, using standard overhead rates (i.e., direct labor hours) to distribute costs is not feasible.

IBM Report

In 2003, the Department contracted with IBM at a cost of $242,500 to perform a study related to overhead. The intent of the study was to validate current processes and compare them to best practices. IBM issued the final report in late 2003. During the study, IBM reviewed background material, which included a review of the Department's internally generated overhead evaluation report, issued February 2002, interviewed management and staff, administered an internal DWR survey, performed an overhead cost analysis and researched best practices.

The following are the findings IBM reported to the Department (note that all of these findings are from the November 20, 2003, IBM report):

Finding #1:

DWR is not adequately managing and controlling overhead services costs and lacks the measurement processes and tools to do so. DWR does not have a comprehensive view of overhead services, i.e., the total costs of services, who is performing the services, outputs of overhead services and the unit costs of output. Additionally, performance measures are not being used to determine efficiency and relevance of overhead service delivery.

IBM Recommendations:

- Implement activity-based costing for overhead processes to determine specific overhead activity and services costs.
- Develop performance measures for overhead cost services.
- Implement a business intelligence tool to pull existing data out of systems and present in a user-friendly format.

Finding #2:

The current cost allocation method does not recognize different consumption patterns for services. DWR combines overhead costs into a single cost pool and allocates those costs on the basis of an organization's total salaries and wages. Using the traditional accounting method can assign specific overhead costs to all divisions even though only a few divisions use the service.

Additionally, this accounting method treats all overhead costs the same even though they are consumed differently.

IBM Recommendations:

- Develop more detailed cost allocation methods.

- Allocate actual costs rather than budgeted costs.

Finding #3:

Some overhead services should be treated as direct charge centers and the services should be billed internally to users. A common practice in private industry and government is to internally bill for services as a means to control discretionary usage and to encourage economic usage of high cost services. Examples of such services that could be direct charge centers in DWR are printing/photocopying, graphics and Bryte Chemical Lab.

IBM Recommendation:

- Create direct charge centers for selected overhead services.

Finding #4:

Some overhead cost reduction could be achieved through implementation of alternative delivery methods. For the most part, DWR either provides overhead services through the use of embedded staff or through centralized overhead functions. Other service delivery methods may help reduce costs while maintaining or improving service quality.

IBM Recommendation:

- Implement alternative delivery methods for selected overhead services.

Finding #5:

DWR has inadequate mechanisms to address customer satisfaction concerns. DWR does not collect on a formal, regular basis customer or service quality information, such as process cycle time, or customer satisfaction that would allow it to monitor overhead service quality and trends.

IBM Recommendation:

- Increase overhead services organizations' focus on customer assistance.

Procedures Requested

- Obtain the SWP/DWR overhead rates for the last fours years and 2009, if available.

- Verify that 2008 and 2009 overhead rates contain appropriate costs. (This includes determining if costs related to the FloodSafe program or the new project communication system are included in overhead).

- Identify any inappropriate costs contained in 2008 or 2009 rates.

- Provide a summary of recommendations from the draft IBM Report titled "California Department of Water Resources Overhead Services Cost Management," dated October 14, 2004, and note any recommendations adopted by the Department.

Procedures Performed

- Calculated the percentage of total overhead costs to total operating expenses for 2005–2008. Investigated any variances greater than 5% year over year.

- Completed detail testing of the individual costs that are included in the 2008 overhead balances within SAP by performing the following:

  We selected large dollar cost elements within each of the Department's main overhead categories (e.g., GM, LM, staff benefits and POE). These overhead categories represented $62.4 million of total overhead, or 62.3%. We drilled within SAP and selected a sample of 25 individual overhead cost items for testing.

- Inquired as to the inclusion of costs related to the FloodSafe program and new project communication system within overhead.

- Discussed the findings in the IBM report mentioned above with the Department personnel and obtained responses as to what has been done to mitigate those findings.

Findings and Results

1) See below for our calculation of total overhead costs to total operating expenses for 2005–2008 (amounts have been rounded for presentation purposes).

	2005	2006	2007	2008
Total overhead costs	$100,421,000	$105,252,000	$100,225,000	$100,144,000
Total operating expenses	578,381,000	783,683,000	772,125,000	845,500,000
Percentage	**17.4%**	**13.4%**	**13.0%**	**11.8%**

We obtained the total overhead costs for 2005–2008 from SAP. We obtained the 2005, 2006 and 2007 total operating expense balances from the DWR audited financial statements. The 2008 total operating expense was obtained from SAP. **The budgeted amounts for 2009 were not uploaded into SAP until December 2008. As a result, we were unable to compare the historical costs to the future estimates.**

We noted that the 2005 calculated overhead percentage was not consistent with the calculated overhead percentages for 2006, 2007 and 2008**.** Our review of the 2006 and 2005 comparative financial statements indicated that this variance was primarily due to a $205 million increase in total operating expenses from 2005 to 2006. This increase was due primarily to increases in power purchases of $135 million plus a reduction in deferred expenditures (causing a related increase in expenditures) of $106 million, which appears reasonable. These increases were offset in part by decreased O&M expenses of $36 million in 2006. The decrease in the total overhead percentage from 2005 to 2006 was expected based on the large increase in total operating expenses in 2006.

2) **We identified a drill-down issue within SAP while performing our procedures.** This issue did not affect overhead costs but did affect the accuracy of the overhead reports being generated out of the system. In order to pull the overhead amounts, we reviewed numerous reports within SAP that displayed overhead costs from different perspectives. During our review of the ZFM3 2007 overhead report, we noted a discrepancy between the total per the cost element and the supporting detail within SAP. Through discussions with the Department, we determined the discrepancy is due to an SAP reporting issue that arose during the conversion to the new SAP system. The amount in the drilled-down detail includes overhead expenses related to multiple periods, as opposed to only drilling for the period selected. The issue has been resolved within SAP for subsequent years.

We recommend that the Department correct the reporting issue within SAP for all years that continue to be affected, including any past years.

3) We reviewed the descriptions within SAP for our 25 selections and investigated any items that did not seem appropriately classified as overhead. Through this testing we determined all items selected were appropriately included in overhead costs.

4) **As of December 2008, we were unable to get a response from the Department as to whether any costs related to the FloodSafe program were being included in the staff benefits, POE or LM overhead categories.** The Department has indicated that costs related to the FloodSafe and the new project communication system programs are not included in GM overhead. FloodSafe is an integrated flood management and emergency response system throughout California. **We do not believe these costs should be treated as overhead as they do not benefit the SWP as a whole.** During our overhead procedures, nothing came to our attention that would indicate any costs associated with these programs are included in overhead.

5) The Department provided the following responses to the findings noted in the IBM overhead report (these are the written responses obtained directly from the Department):

Department's general responses to the findings within the IBM report:

- DWR migrated to a new "public sector" version of SAP in July 2006 and continued in stabilization mode for several months after go-live. Some processes dealing with overhead costs have changed (including assessments), while other processes that were available in the old system (e.g., budget planning tool) have yet to be designed and employed in the new system.

- The passage of Propositions 1E and 84 in November 2006 will provide an influx of billions of dollars in funding to DWR for flood control and integrated water management. As a result, programs have expanded and new programs are being implemented. The need for overhead support has also increased as the additional workload cannot be absorbed; however, the legislature has not approved additional overhead resources to-date.

- The Department has undergone and will continue to undergo major organizational restructuring. A large State Water Project reorganization will go into effect on January 1, 2009; with several other significant functional and structural changes throughout the Department effective July 1, 2009.

- The Department found that some of the recommendations in the IBM report were not cost-effective. In other words, it would be more costly to implement a direct charge system in some cases versus keeping certain services in overhead.

Department's Response to IBM Finding #1:

- As recognized in the IBM report, determining overhead costs would require a monumental effort due to the complexity of the Department's programs, funding sources and financial reporting requirements.

- During the FY 2006-07 budget planning process, DWR's executive management directed general management organizations to reduce their budgets as a way to control overhead costs. This forced the GM organizations to look more closely at their actual expenditures, which resulted in reductions during the planning process. With the major expansion of the Department's programs since then, it has not been feasible to keep the overhead budgets at the same reduced levels from three years ago.

- During the migration to the new version of SAP, the Department attempted to make overhead costs more visible by parsing out the various components that are assessed to the funds. However, the resulting effect complicated the assessment process to the point that only a select few people in the Department understand the flow of costs and how to interpret the data.

- Under the direction of the former deputy director of business operations, some general management organizations were tasked with tracking their monthly outputs, including items of mail processed, number of invoices paid, number of funding strips processed, number of help desk tickets completed, etc. However, we had not gotten to the point of calculating the other important component of the equation: output costs. This exercise required a significant amount of staff work and was a "cultural change" for many DWR employees, which met with some resistance. With the appointment of a new deputy director, the Department no longer tracks this type of information.

- We are aware that the division of technology services is developing Cognos reports with the goal of providing useful budget and expenditure data to help manage the Department's resources. The timeframe for roll-out of the Cognos reports is not known.

  EY Comment: We obtained an update on the status of the Cognos reports at the November Business Process Committee meeting. It is expected that some of the reports will be rolled out in the January to February 2009 time frame. We will confirm that the division of technology services has developed these Cognos reports during our 2009 procedures. Additionally, we concur with IBM's recommendation that the Department develop performance measures for overhead cost services.

Department's Response to IBM Finding #2:

- The IBM report raised the issue of inequities associated with allocating overhead costs using planned costs vs. actual costs. With the migration to the new version of SAP, the Department now uses actual costs to assess monthly overhead to the programs.

- For the first two years using the current SAP system, pro-rated operating expenses (POE) were allocated to both general management and line management cost centers. Beginning in FY 2008-09, the Department changed its overhead allocation methodology such that POE is assessed only to line staff cost centers.

- Another example provided in the IBM report is the benefit of allocating division of technology services costs by number of PCs versus our current allocation method. The former enterprise business and special projects office conducted analyses on some of the recommendations and found that the difference was not significant enough to warrant a change.

- In FY 2006–07, the Department developed and employed a new methodology for distributing state pro-rata costs. Pro-rata includes costs generated by state central service agencies and are paid by special-funded programs (including the state water project, the California Energy Resources Scheduling, energy resources program, and the dam safety program). The distribution of pro-rata is based on different workload factors that have a direct correlation to each separate cost component (similar to the approach suggested in the IBM report). To employ this methodology for the entire Department's overhead costs would be a significant effort, including the redesign of SAP.

EY Comment: We recommend that the Department continue to implement more detailed cost allocation methods. As noted by IBM, improved allocation of overhead costs will allow the Department to more accurately distribute overhead costs across service organizations.

Department's Response to IBM Finding #3:

- Prior to SAP, services including reprographics, graphic services, photography and audio-visual equipment services operated on a direct-charge basis. The decision to move these costs into overhead was made during the first implementation of SAP. The Department is considering moving some services out of overhead, where feasible. In particular, DWR management has decided to transition the Bryte Chemical Laboratory back to a direct charge service, effective July 1, 2009.

  EY Comment: We recommend that the Department continue to update the Contractors as additional progress is made on this item.

Department's Response to IBM Finding #4:

- DWR is currently transitioning to centralized contracting with the goal of streamlining the process and providing enhanced customer service. This will be a new process for the Department in that some contracting responsibilities have historically been embedded in the line organizations. It is too early to determine if centralization will achieve overhead cost savings and efficiencies.

- The IBM report gives an example of automating certain human resources tasks, such as updating employee personal information. DWR already enables employees this capability through a self-service Web-based portal. Employees can update their personal information, enter their timesheets, review their leave balances, create a delegation and review training information through this portal.

- DWR will also implement the state's automated travel expense reimbursement system (CalATERS), which is the state controller's office's solution for effectively managing travel claim processing. Departments using CalATERS will achieve efficiency through automation and will reduce the time required to process travel advance and expense reimbursement payments.

- DWR is also moving forward with a document management system that will be implemented over the next few years.

  EY Comment: As noted in the Department's response, they are working to make a number of improvements in this area. We recommend they continue to update the Contractors as additional progress is made.

Department's Response to IBM Finding #5:

- Under the direction of the former deputy director of business operations, DWR conducted a customer service survey that included input from both line organizations as well as business operations units. The survey was helpful in that it captured ratings of certain overhead units, as well as actual comments from the survey participants. The division of fiscal services managers spent time reviewing the data and discussed ways to improve customer service. Customer service continues to be a high priority for the fiscal division. The Department is not aware that any follow-up surveys are planned.

  EY Comment: We recommend that the Department conduct customer service surveys on an ongoing basis to ensure that customer concerns are being addressed. The use of follow-up surveys is the only effective tracking mechanism to measure progress in this area.

DEBT SERVICE ALLOCATION

General Background

The debt service allocation to individual projects varies depending on whether the proceeds are being used to repay commercial paper (these amounts represent new money) or are being used to refund a preceding bond series. For new money, the allocation to individual projects is based on the amount of commercial paper previously used for each project. For refunding money, the allocation to individual projects is based on the project allocation of the debt being relinquished.

At the request of the Contractors, in 2008 the Department revised the methodology for issuing refunding revenue bonds so that bonds are not refunded in aggregate amounts, but are instead refunded based on individual bonds for individual projects. This was done to lessen the impact of issuing revenue bonds to refund older issuances, which might have a dramatically different term and repayment structure than the original bonds.

Procedures Requested

- Review the methodology used by DWR to form the allocation basis of bond proceeds to individual projects and ensure consistency with the water supply contract and overall sound accounting.

- Review and confirm that the actual allocation of the bond proceeds is consistent with the methodology reviewed above.

- Review DWR's method for allocating bond issuance costs, underwriter's costs, etc. to the individual projects. Determine the reasonableness of the allocation methodology used.

Procedures Performed

- We obtained the allocation schedule of series AE by project (for new money) and refunded series, tested the clerical accuracy and selected one series being refunded (series AB) for testing. Additionally, we used this schedule to determine if bond issuance costs and underwriter's discounts are being allocated in the same proportion as the principal amounts between projects.

- We obtained the analysis performed by Montague de Rose (a full-service, independent financial advisory firm) to ensure that the refunding of series AB was resulting in a minimum of a 3% net present value savings. If a refunding does not meet this minimum amount of savings, the opportunity is foregone because the opportunity is not considered cost-effective.

- We obtained the Department's calculation of the amounts to be removed from the debt service schedule for series AB and added to the debt service schedule for series AE, by project, as a result of the refunding. This calculation takes the original allocation for series AB for 2008 and forward, removes the adjustment for the recreation cash defeasance and calculates the percentage of each project's debt service, by year, of the total principal outstanding. These percentages are applied to the amount of the principal for series AE allocated to the refunding of series AB.

- We agreed the total principal amounts for series AB prior to the refunding for 2008–2029 to the debt service schedule as of October 1, 2007, less the adjustments for the recreation cash defeasance.

- We also haphazardly selected one project from the original AB allocation (Reid Gardner) and traced the original principal amounts to the debt service schedule as of October 1, 2007.

- Using the debt service schedule for series AB prior to the refunding, we recalculated the percentage of each project's proportion of the principal amount due by year to the total principal payment due by year.

- The total principal amount of series AE allocated to the refunding of series AB is $178,535,000. Using the percentages calculated in the previous step and the revised annual amounts due provided by Montague de Rose, we recalculated the amount of series AE debt service being applied to each project by year as a result of the refunding.

- We haphazardly selected one project (Reid Gardner) and agreed the updated principal amounts to the debt service schedule as of October 1, 2008.

- The actual interest rates were provided by Montague de Rose. The interest was calculated by using these interest rates and the updated principal amounts based on the amount allocated from series AE. We re-performed this calculation and haphazardly selected one project (Reid Gardner) and agreed the interest amounts to the debt service schedule as of October 1, 2008.

Findings and Results

1) **The Department does not have formal documentation of the process used to allocate bond proceeds to the WSRB surcharge and relevant projects. We strongly recommend that the Department work to formulate documentation of this methodology and process.** This will ensure that the allocation is consistent and done correctly. The Department was able to provide a description of the unofficial process in place, (described briefly above) around which we formed our specific procedures.

2) **The original interest allocation for series AB was prepared using an estimated interest rate of 4%, as the actual variable rates were unknown.** In testing series AB, we noted that the original allocation of this series was based on an estimated coupon rate, since the actual rate was variable. As the external firm used actual rates, this caused variances between calculated amounts. **We were unable to determine the effect that this assumption had on the Contractor's bills. The Department has indicated that it will include the true-up in the December re-bill. We recommend that the Department inform the Contractors when an estimated rate is used for an allocation, as this will cause fluctuations to debt service payments.** To allocate the refunded amounts, the Department used the original individual project proportions and the actual interest rates calculated by the external firm to determine the amounts to be refunded.

3) **The Department was unable to show EY where the bond issuance costs and underwriter's discount (totaling $3.5 million for series AE) were included in the debt service schedule dated October 1, 2008.** We verified that the allocation among projects was consistent with the allocation of principal amounts using the schedule provided for series AE. Through inquiries with the Department, it is our understanding that these amounts are added to the allocation of principal and interest amounts allocated out to various projects; however, when reperforming the calculation for series AB above, we were unable to identify these costs. **As of the date of this report, we were unable to determine if these costs were included. As a result, we were unable to determine the impact to the Contractors.**

RATE MANAGEMENT CREDIT CALCULATION PROCEDURES

General Background

Each year, the Department performs a "financial analysis," which is used to determine the excess revenues that are available to be distributed to the Contractors in the form of RMCs as provided under the terms of the Monterey Amendment. This financial analysis is prepared using revenue and expenditure information from the B-Tables or other source documents. The Contracts also contain specific steps and provisions to be followed with regard to the calculation of revenues available and the allocation of the RMCs.

Procedures Requested

- Obtain the Department's most recent final RMC financial analysis.
- Verify the amounts presented on the financial analysis used to determine RMC are consistent with the B-Tables for the current SOC year and the prior two calendar years.
- Identify significant variances between the current amounts for the prior two years and the amounts previously identified by the Department when the RMC calculation was performed for that year (i.e., a large increase in the DWC minimum costs compared to the original estimate for the year).
- Review the Department's annual reconciliation of the revenue fund to ensure that only the funds needed are retained in the fund with all the excess revenues transferred to the bond fund included in the revenues available for RMC.
- Review the Department's spreadsheet used to allocate RMC and ensure it is clerically accurate and consistent with the allocation provisions outlined in the Contracts.
- Ensure the Department has documentation supporting the methodology used for the calculation of RMCs.
- If such documentation exists, review and confirm that the RMC calculation is being performed in a manner consistent with the documented methodology.

Procedures Performed

- Obtained the "Revenues Available for Rate Management Credits" schedule prepared for the December re-bill of the 2008 SOC. Through inquiry of the preparer of the schedule, verified this was the most recent final calculation.

- Obtained the informal instructions retained by the Department as to how to prepare this calculation (no formal instructions exist).

- Agreed historical amounts to the schedule tested in the prior year (the original calculation for the 2008 SOC). Investigated any changes to ensure they were appropriate.

- Haphazardly selected 35 items from the 2003–2008 columns to ensure that the amounts were entered consistent with the instructions in place. Investigated any differences between the support provided and the amounts in the schedule.

- Obtained explanations for significant fluctuations in historical costs and future cost estimates.

- The Department's process for allocating RMC to Contractors as well as the supporting methodology and consistency with the Contract is tested as part of our regular annual procedures. For procedures performed refer to the Monterey Amendment discussion within Section 4 of this report.

Findings and Results

1) **There is no formal documentation of the process for preparation of the RMC calculation, which we believe could result in inconsistencies and inaccuracies within the calculation.** There are instructions for completing the calculation; however, these have been created through discussions between staff and do not provide explicit instructions as to where to obtain all of the information. There is also not enough detail in the Contract to determine if the instructions are correct and/or complete. **We recommend that the Department work with the Contractors to create a detailed set of instructions for preparing the RMC calculation. We also recommend that the Department work to improve the informal instructions currently in place if no formal instructions will be created.**

2) **The Department was unable to provide support for the 2004 original over/under amount used in the calculation.** The individual who populated the data is no longer an employee at DWR. **We recommend that the Department document the process used for accumulating the data utilized in the RMC calculation, as well as retain the actual support generated that is input into the RMC calculation for each version.**

3) **The "interest (credits)/charges on prior over/under payments" do not agree to the support provided for 2005 and 2006.** The amounts populated for prior years have not been adjusted to reflect the most current information. More specifically, the amount for the 2005 transportation variable OMP&R costs per the RMC calculation is $600 thousand and the amount per the support is $500 thousand. The amount for the 2006 transportation variable OMP&R costs per the RMC calculation is $500 thousand and the amount per the support is a negative $500 thousand. The amount for the 2006 transportation minimum OMP&R costs per the RMC calculation is a negative $1,400 thousand and the amount per the support is a negative $900 thousand. **We recommend that the Department update the RMC calculation to reflect the most recent information.**

4) **The "Devil Canyon-Castaic debt service transfer" amount does not agree to the support provided for 2005.** The amounts populated for prior years have not been adjusted to reflect the most current information. More specifically, for year 2006 and forward the amounts are based upon the bond official statement. However, the amounts for 2005 and prior are based on an estimate that was previously provided. **We recommend that the Department update the RMC calculation so that all years reflect the bond official statement.**

5) **The "Delta Water Charge capital" amount for 2007 was calculated using incorrect support.** The amount should have been calculated based on the December re-bill of the 2008 SOC. We haphazardly tested five contractors from the schedule provided as support and noted that the amount for four of the contractors did not agree to the December re-bill of the 2008 SOC. Specifically, Alameda County FC&WCD, Zone 7 was listed at $1,046,006 and should have been $968,856, Kern County Water Agency was listed at $12,958,210 and should have been $10,465,603, San Luis Obispo County FC&WCD was listed at $324,367 and have should been $282,405 and San Bernardino Valley MWD was listed at $1,331,203 and should have been $1,159,047. We noted that all of these amounts used agreed to the original 2008 SOC. **We recommend that the**

Department update the RMC calculation to reflect the information in the December re-bill of the 2008 SOC.

6) **The "Minimum Conservation Costs" plus the "Minimum Conservation Cost Adjustment" do not agree to Bulletin 132-07, Table B-13 for 2005 and 2006.** The amount for 2005 per the RMC calculation is $81.1 million and the amount per Bulletin 132-07, Table B-13 is $76.0 million. Additionally the amount for 2006 per the RMC calculation is $71.8 million and the amount per Bulletin 132-07, Table B-13 is $54.4 million. **We recommend that the Department update the RMC calculation to reflect the most recent information. For example, although the calculation for the 2008 SOC would have been prepared based on Bulletin 132-07 data, the calculation for the 2009 SOC should be prepared using Bulletin 132-08 data. The figures (including historical data) should be updated to the current Bulletin each year to ensure the most accurate information is being used.**

7) **There was conflicting support given for the "Original Recreation Allocation" for 2005.** In the calculation, $9.8 million was used for the 2005 original recreation allocation amount. However, we received two versions of support for this item. One version agreed to the $9.8 million included and the other version indicated that the amount should be $10 million. There is no consistency between reports being created for this calculation and it was difficult for us to determine which was the correct version. The 2003–2005 recreation cost amounts were populated from one report and the 2006–2007 amounts were populated from a different report. **We were unable to discuss and resolve the difference in the reports with Fiscal in the current year, as they were working to complete the Department's financial statements. We recommend that the Department be consistent in the generation of data used in the RMC calculation. Additionally, when information is received from a source that is different than what was historically used, the reason for the change should be documented.**

8) **The "Delta Water Charge Revenue" amount for 2007 does not agree to the SOC.** This amount should agree to the March 2007 re-bill of the 2007 SOC. The amount per the RMC calculation is $51.9 million. Through discussions with the Department, the correct amount based on the March re-bill, excluding RAS credits, should have been $57.9 million. We were unable to agree this amount directly to the March re-bill. **The Department was not aware of why the amounts had not been updated to reflect the**

March re-bill amount of $57.9 million. We recommend that the Department update this amount in the RMC calculation.

Update of Prior Year Finding

During our prior year procedures we noted that the 2004 Recreation Allocation amount was incorrectly input as an estimate of $8.7 million, while the actual was $9 million. **During our 2008 procedures, we noted that the 2004 Recreation Allocation had been updated to the correct amount.**

SECTION 4

DETAILED DISCUSSION OF THE 2008 REGULAR PROCEDURES

Section 4 of our report contains a detailed discussion of our regular procedures performed during 2008.

OFF-AQUEDUCT POWER FACILITIES

General Background

In an effort to provide the SWP with a cost-effective energy supply, the Department has participated in several OAP facilities. These facilities have included Reid Gardner Unit 4 (a coal burning facility), and the Bottle Rock and South Geysers Geothermal Power Plants. Since December 1990, only the Reid Gardner facility has been producing energy.

The following is a description of the process to initially estimate and subsequently update OAP cost estimates. We will utilize the 2009 SOC as an example to assist in the explanation.

OAP costs are estimated in the July 1 SOC. For example, in June 2008, the Department prepared the "Allocation of 2009 Off-Aqueduct Power Facility Charges" used to prepare the July 1 version of the 2009 SOC. Payments will be made monthly based on these estimates. No revisions are made to the SOC after this calculation is completed.

In May of the current SOC year, the Department revises its initial calculation of OAP costs for changes in the Contractors' requested water deliveries and to update for the actual net costs of OAP facilities, which include identifiable power revenues from January to May. For example, in May 2009 the Department will prepare the "May Allocation of 2009 Off-Aqueduct Power Facilities Charges." This is generally finalized by August of the same year. If necessary, the Contractors are issued any identified refund or additional billing in the following year (i.e., 2010).

Historically, the "May Allocation of Off-Aqueduct Power Facilities Charges" has been prepared using the most recent Bulletin 132, Table B-5B. However, in 2008, in an attempt to make the May allocation more accurate, the Department utilized the actual deliveries through June 2008 and developed a projection through the end of the calendar year.

In the following year, preliminary end-of-year adjustments are made. For example, in 2010 the "Preliminary Year-End Allocation of 2009 Off-Aqueduct Power Facilities Charges" will be prepared. Any costs that can be trued up at this time are adjusted, and revenues received during June – December of the previous year are taken into consideration. Any refunds due or additional billings are issued to the Contractors in the subsequent year (i.e., 2011).

The OAP costs for a given year are finalized one year after the preliminary end-of-year adjustments are made. For example, the final "Year-End Allocation of 2009 Off-Aqueduct Power Facilities Charges" will be completed in 2011. The Contractors are issued any refunds or additional billings in the subsequent year (i.e., 2012).

The following table has been included for informational purposes and illustrates the actual OAP costs billed, paid and refunded over the last five years.

CHARGES, REVISIONS, AND REFUNDS OF COSTS FOR OFF-AQUEDUCT POWER FACILITIES

Date	Transaction	2004	2005	2006	2007	2008
July 1	Initial estimate of charges	$ 93,202	$ 100,703	$ 106,087	$ 124,268	$ 138,602
Revisions	Adjustment of cost estimates**	(3,420)	5,208	5,359	(15,845)	(3,639)
	Total adjusted end-of-year OAP costs (final through 2006)	$ 89,782	$ 105,911	$ 111,446	$ 108,423	$ 134,963
	Total power sales not included in end-of-year net costs above**	$ 9,624***	$ 21,324	$ 16,922	$ 16,582	$ 2,359*

* Revenue is actual through May 2008.

** Information for 2007 and 2008 remains preliminary as of our report date.

*** Lower due to sale of power during 2003 to NPC.

Off-Aqueduct Debt

The total off-aqueduct debt outstanding as of December 31, 2008, is $240.8 million, which is comprised of $139.4 million related to Reid Gardner Unit 4, $67.3 million related to Bottle Rock and $34.1 million related to South Geysers. This is significantly higher than the value of OAP facilities owned or invested in by the Department. **We continue to recommend that the remaining off-aqueduct debt be extinguished as funds become available. When these bonds are paid off or retired, the Contractors realize a dollar for dollar savings on their SOCs**.

Procedures Performed

- Obtained the "May Allocation of 2008 Off-Aqueduct Power Facilities Charges" and tested the clerical accuracy of the schedule.

- Vouched cost and revenue items greater than $100 thousand in conjunction with our power testing for the calendar year ended December 31, 2007.

- Obtained the "Preliminary Year-End Allocation of 2007 Off-Aqueduct Power Facilities Charges," tested the clerical accuracy of the schedule, and cross-referenced the data from the power spreadsheets. Investigated any differences greater than $500 thousand.

- Obtained the "Year-End Allocation of 2006 Off-Aqueduct Power Facilities Charges," tested the clerical accuracy of the schedule, and investigated any changes greater than $500 thousand from data tested in previous years.

- Ensured that the appropriate billings and/or refunds had taken place based on the allocations previously mentioned.

- Obtained the "Allocation of 2009 Off-Aqueduct Power Facilities Charges," tested the clerical accuracy of the schedule, and ensured the allocation of charges agreed to the current Bulletin 132, Table B-5B data and the Contractors' bills.

Findings and Results

1) **The Department does not estimate power revenues in the initial or May allocation of OAP facilities charges, resulting in over-collections from the Contractors.** Through

the course of our testing in the current year, we noted that the Department continues to estimate costs related to the OAP facilities. However, they do not include even a conservative or minimum estimate for a full year of power revenues in the initial or May allocation of OAP facilities charges. As such, the Contractors are receiving a refund due to power revenues after the May allocation of OAP facilities charges is completed, and another refund after the preliminary year-end allocation is completed (provided that there has not been a related increase in costs to offset the refunds). **We recommend that the Department include a preliminary estimate of revenues in the initial allocation of OAP facilities charges, and update this estimate in the May allocation to minimize over-collections from the Contractors.** Through our discussions with the Department, we determined that the Department is willing to consider including an estimate for revenues if interest is expressed from the Contractors.

2) **The 2006 final year-end allocation resulted in a total under-billing of $1.2 million to the Contractors.** This resulted from the removal of estimated costs of $3.1 million under the Reid Gardner O&M, insurance and administrative cost category that had been included when the 2006 preliminary year-end allocation was completed, and the removal of $4.3 million in OAP sales that resulted from a reconciliation of peaking energy charges showing that the Department over-billed the NPC. This was identified subsequent to the preparation of the 2006 preliminary year-end allocation. **We verified that the Contractors had not been billed for this under-collection as of November 2008. Under the timeline discussed in the general background section above, the supplemental invoices would not be sent out until 2009. We recommend that the Department reduce the lag to provide a timely settlement with the Contractors.**

3) **The 2007 preliminary year-end allocation showed a projected over-billing of $29.3 million to the Contractors.** The primary contributors to this difference are the true-up of estimated costs for Reid Gardner to the actual costs (represents $15.8 million of the decrease in costs) and the true-up of OAP sales to reflect actual revenue for the calendar year (results in an increase of revenues of $13.5 million, causing a related decrease in costs). Additionally, we noted that an additional $1.6 million was included in the Reid Gardner O&M costs in anticipation of future invoices. We obtained a breakdown of the $1.6 million and noted that there was no support for $500 thousand of the costs. **We recommend that the Department refrain from including unsupported cost estimates in the preliminary year-end allocation as the allocation is prepared numerous months after the end of the previous calendar year (i.e., the 2007 preliminary year-**

end allocation was finalized in August 2008) and should no longer rely on unsupported estimates. We verified that as of November 2008, the projected over-billing had not been refunded to the Contractors. Refer to the second finding above for our recommendation on this issue.

4) **Costs related to 2008 of approximately $366 thousand were incorrectly included in the preliminary year-end allocation of 2007 OAP facilities charges.** As part of our 2007 power invoice testing procedures for Reid Gardner, we noted two invoices related to insurance that had service periods covering both 2007 and 2008. The first amount was $175,818 and related to the period of June 2007 – 2008. The second amount was $296,923 and related to the period of September 2007 – September 2008. We also noted an invoice amounting to $178,833 related to property taxes that had a service period solely in 2008. All three of these amounts were included in the 2007 preliminary year-end allocation. **We recommend that the Department follow accrual-based accounting and adjust these costs to match the proper service periods.**

DELTA WATER RATE

General Background

Contractors are charged for the capital and minimum costs of building, operating, and maintaining the SWP's water storage (conservation) facilities through the DWC. Costs associated with four of the major facilities (Oroville Reservoir, Delta Facilities, California Aqueduct to San Luis Reservoir, and San Luis Reservoir) comprise the majority of this charge. The facilities store, or convey to storage, water for future delivery to Contractors via the California Aqueduct. The Delta facilities represent a water accumulation and diversion point, and a portion of the California Aqueduct and San Luis Reservoir function as storage facilities.

The DWC is a present worth-based calculation of costs, payments and remaining Table A water to be delivered. This calculation is used to develop a cost per acre-foot applied to the Contractors' Table A for the respective year. The following outlines the key components of the DWC determination:

- ***Historical Costs***. The historical costs included in the DWC computation are those compiled in the Department's accounting system for conservation cost centers. As with most historical costs included in Contractor billings, these costs are subject to revision if recent developments provide information that warrant the change. The costs are segregated by cost component (i.e., minimum and capital), division and year.

- ***Future Costs***. The Department also includes estimates of future minimum and capital costs anticipated for the completion and future operation of the facilities in the DWC. Capital costs are projected to the completion date of the facilities, currently 2035. Minimum (operating) costs are projected through the end of the project repayment period (2035).

- ***Contractor Payments***. Payments received from Contractors for past billings offset the historical costs included in the computation.

- ***Oroville Power Revenues***. Actual and estimated power revenues derived from the theoretical sale of power to the SWP generated from the Oroville facility through the end of the designated project life (2035) also offset the above costs (historical and future). The Department is currently estimating future years' capital Oroville power revenue at $16.1 million per year through 2029 and at $14.7 million per year from 2029 to 2035.

- ***Water Deliveries***. To establish a denominator for the DWC, total Contractors' Table A water from the current year through 2035 is accumulated and incorporated into the computation at its present value.

- ***Determining Present Value of DWC Components***. After all of the information above is accumulated by year (costs being net of Contractor payments and estimated Oroville revenues), the Department applies a time value factor to the cost-estimates so that all costs are stated in current year dollars. In addition, the same factors are applied to annual Table A water so that deliveries are stated on a comparable basis. The PIR is used as the basis for establishing the annual time value factors. The Delta Water Rate is then determined by dividing the total operating and capital costs of conservation facilities in the current year dollars by the current time value of the water.

The Department regularly includes estimates of costs in Contractor billings and in the case of transportation minimum charges, adjusts the next annual billings upward or downward to reflect actual costs when they are known; however, variances from cost estimates included in the DWC are not treated in the same fashion. According to the Contract, when the Department adjusts estimated costs to actual costs in the DWC, a single year refund or invoice is not generated. Rather, the adjustment is factored into the DWC calculation, and effectively is "refunded" or "charged" back to the Contractors over the remaining project repayment period (27 years as of December 31, 2008) via a changed DWC.

Propriety of Future Cost Estimates

The estimates used for determining the minimum component of the DWC are obtained from several sources, including the Division of Planning, the Division of O&M (which includes energy) and SWPAO. The cost estimates typically consist of a three-year projection based on activities anticipated by the respective division. The Department adjusts the short-term projections for inflation and extends the costs through the remaining estimated life of the project or the term of the cost center. These costs go through several modifications to arrive at the billing computations.

The amounts used for determining the capital component of the DWC are developed directly from capital budgets provided by the Division of O&M and the DOE.

Procedures Performed

- Recalculated the capital and operating costs per Bulletin 132-08, Table B-13 using SAP, (we included the effect of the recreation adjustment made in the prior year, see prior year EY report for detail of the exact amounts). Investigated all differences greater than $1 million from the published data.

- Compared the current year figures from SAP for Table B-13 to the prior year figures from SAP for Table B-13 (for example, we compared the 2007 amount pulled in the current year to the 2007 amount pulled in the prior year) in order to determine if large adjustments are taking place year over year. Inquired as to the cause of any changes greater than $1 million.

- Tested the "Entitlement Water Present Worth to 2008" used in the calculation of the current DWC.

- Recalculated the Delta Water Rate for Non-Monterey signers using the data from SAP. Investigated differences in the rate greater than $0.50.

- The Department's current methodology of computing the DWC fails to acknowledge that Contractors' make semi-annual capital and monthly minimum payments and, therefore, deprives them of any related interest benefits. As such, we calculated the interest benefits foregone by assuming one annual payment is made.

Findings and Results

1) **The future projections used in the DWC are not auditable due to the inclusion of estimates in future years' costs. We recommend the Department allocate sufficient resources toward incorporating sound documentation standards to clearly document changes in the DWC. As part of the billing process, we suggest that the Department prepare an analysis of all charges affecting the DWC, such as a listing of each cost center affecting the DWC and the allocation of the cost center between the DWC and other repayment methods. Converting to a Delta minimum PAYGO method would result in a "simpler" repayment method and would provide the Department the necessary cash flows to fund current year expenses. Without the implementation of the revised capitalization policy and appropriate funding mechanisms, it is likely the DWC would continue to fund various capital items, such as extraordinary O&M projects, as annual expenses, which we believe should be capitalized.** As is apparent from the following analysis, modifications to future cost projections incorporated into the DWC computation can have a significant impact on the minimum component of the rate in any given year. The following table summarizes the historic impact of fluctuations in future cost estimate amounts (escalated) on past and present rate determinations:

Delta Minimum Cost Estimates for Years 2008–2035
(in millions except per acre-foot amounts)

Billing Year	2008 to 2035 Future Cost Estimates	Change From Previous Year	DWC Effect Per Acre-Foot (Based on 2008 PV of water)	% Rate Change
2008	$ 2,028	$ 347	$ 4.14	26.15%
2007	1,681	76	0.99	6.66
2006	1,606	54	0.65	4.58
2005	1,551	40	0.36	2.64
2004	1,512	24	0.22	1.59

2) **The capital component included manual additions of $200 million related to the costs to implement an amendment to the Four Pumps Agreement, which is to further mitigate fish loss at the Delta Pumping Plant. The minimum component included manual additions of $128 million related to the future cost estimates for the DHCCP.** We identified these manual additions through our recalculation of the capital and minimum components. The Department does not have documents supporting the propriety of these estimates. **The Department has indicated that it will remove the DHCCP costs from the DWC in the December re-bill.** This is expected to reduce the minimum component by approximately $1.90 per acre-foot. We recalculated this amount, and determined the estimate was reasonable. **We recommend that the Department also remove the costs related to the Four Pumps Agreement, as there is no support for the cost estimates currently being included in the capital component. We estimate this would result in a decrease to the Bulletin 132-08 capital cost component of the DWC of approximately $2.47 per acre-foot.**

3) As part of our procedures, we attempted to obtain explanations for significant fluctuations in the DWC. The Department was not able to provide adequately detailed explanations for many of the changes in the SAP data pulled for Table B-13 between the current year and the prior year, as follows:

Capital Component

- The future costs for 2013 increased by $1.2 million under the Delta component.
- The future costs for 2009 increased by $1.4 million under the California Aqueduct and San Luis component.

Through discussions with the Department, we determined that the capital amounts noted above changed due to updated future projections from the capital budgets. However, we were not able to obtain the capital budgets used to compile the current year figures prior to the completion of our procedures.

Minimum Component

- The future costs for 2008 and 2010 decreased by $6.2 million and $12.2 million, respectively, under the Oroville component.

- The future collections (resulting in related credits to the DWC) for 2008, 2009, and 2010 increased by $3.3 million, decreased by $1.5 million, and decreased by $7.1 million, respectively, under the Oroville Power Revenue component.

- The future costs for 2009 and 2010 increased by $4.4 million and $18.9 million, respectively, under the California Aqueduct and San Luis component.

Through discussions with the Department, we determined that the minimum amounts noted above changed due to revised future projections. As noted above, minimum costs are projected three years into the future. In the current year, projections were updated for 2008–2010. We obtained the Department's calculation and tied out the current year amounts for the Oroville and the California Aqueduct and San Luis components; however, we could not identify the specific reasons behind the large changes from last year's estimates.

We were able to obtain reasonable explanations for all other changes in historical and future costs greater than $1 million. **However, we recommend that the Department provide additional visibility in the changes that occur to the DWC from year to year. The Department should be able to support and provide explanations for significant fluctuations.**

4) The Table A entitlement water within the "Entitlement Water Present Worth to 2008" schedule differed from Bulletin 132-08, Table B-4 by 9,900 acre feet. **We determined that this difference does not have a significant monetary impact (less than $10 thousand on the total present worth); however, the two schedules should be in agreement.**

5) **The Department's current methodology of computing the DWC fails to acknowledge that Contractors make semi-annual capital and monthly minimum payments and, therefore, deprives them of any related interest benefits.** Based on our preliminary assessment, we calculated that the present value of interest benefits foregone to date are approximately $66.8 million for the minimum component and $52.7 million for the capital component. This calculates to a $1.91 per acre-foot impact on the DWC. The Contractors are denied these benefits under current methodology. The time-value of money computation is fundamental to generally accepted accounting principles. **Therefore, we strongly recommend the Contractors and the Department amend this computation provision of the Contract in consideration of the matters discussed**

above. Based on a study performed in the mid 1960s, the Department is uncertain as to the relevance of this issue, believing that this has already been rectified to some extent. Upon further investigation, we noted the originating agreement focuses on various interest calculations. Although the agreement refers to Method C for interest calculations in the water service Contractors Council Memo #105, which is the current method of calculation, we remain convinced an amendment to the calculation should be made. **We recommend that the Department review the current methodology of computing the DWC and determine the effect of not applying interest for the semi-annual payments.**

Update of Prior Year Findings

During discussions between SWPAO and the Contractors, it was agreed that the replacement conservation costs for 2007 to 2009 would not be included in the DWC, as it was for 2004 to 2006. **We recommend the Department and the Contractors evaluate whether a conservation replacement account is necessary, and if so, are modifications needed.**

TRANSPORTATION CHARGES

General Background

Transportation charges relate to the transportation of water through SWP facilities. The annual charge to each Contractor represents each Contractor's proportional share of the reimbursable capital and operating costs of the SWP transportation facilities built for delivering water to individual Contractors.

The transportation charge consists of three cost components: capital, minimum OMP&R and variable OMP&R. The capital cost component consists of, among other things, items such as the planning, design and construction costs of transportation facilities and the power costs allocated to the initial filling of the San Luis Reservoir. The minimum OMP&R component consists of, among other things, items such as the direct and general operations and maintenance costs of the transportation facilities and the power costs for pumping water to replenish losses from transportation facilities. The variable OMP&R component consists of, among other things, power purchase costs and credits from the sale of excess SWP system-generated power.

Procedures Performed

- Selected nine reaches to test: three for capital, three for minimum and three for variable, ensuring that the same reaches were not tested for the same component in the previous two years.

- For the reaches selected, utilized SAP to compute the appropriate charge that should be listed in Bulletin 132-08, Table B-10 for capital, Table B-11 for minimum and Table B-12 for variable.

- Selected a Contractor taking water from each of the reaches selected and re-computed the selected Contractor's billed amount for capital, minimum or variable for the selected year.

- Recomputed the variable unit rate at the selected reach level and the cumulative reach level for the Contractors selected in the previous step. The following table shows the items tested during our current year procedures.

Reach	Area Tested
NB1	Minimum 2007
SB1	Variable 2006
SB5	Capital 2005
CA4	Variable 2005
CA13b	Capital 2006
CA24	Capital 2007
CA30	Minimum 2006
CA35	Minimum 2005
EBX2B	Variable 2007

Findings and Results

1) **During our procedures, we determined that amounts were incorrectly entered in the electronic version of the B-Tables.** When performing the recalculation of Kern County Water Agency – Ag's transportation variable billing for 2005, we came across the following finding. The figure we initially picked up from the electronic version of Table B-5A for Kern County Water Agency – Ag for reach CA13b in 2005 was $21,781. Through our discussions with the Department, we determined that Kern County Water Agency's M&I amounts for reach CA13b had been incorrectly inserted into the Ag

column within Table B-5A. **As the printed B-Tables had not yet been published at the time the error was discovered, the Department was able to correct the amounts for the printed version.** We also noted that, as a result of our finding, the Department rechecked the other reaches for Kern County Water Agency, noting no additional areas that needed to be adjusted. Although the electronic B-Tables were not correct, this amount was properly reflected in the Kern County Water Agency SOC.

2) **Tables B-1 and B-2 do not reflect the effect of permanent water transfers.** During our testing of the transportation capital amounts listed above, we noted that for those Contractors who receive permanent water transfers, additional PUFs must be obtained. These PUFs must be included in order to recalculate the actual amount being billed. **We recommend that the Department develop and publish a report showing the PUFs by reach related to permanent water transfers. This would enable those Contractors who receive permanent water transfers to recalculate their capital transportation charges for a given year using the B-Table data.** The Department is aware of this issue and has currently not come up with a reasonable methodology to present the data within the B-Tables. The Department has indicated that it will address this issue after the next set of water transfers go into effect in 2010.

3) **Tables B-1 and B-2 do not include the East Branch Extension.** During our testing of the cumulative rate factors per Table B-17, we noted that the East Branch Extension is not included in Table B-1 or Table B-2. The Department included a discussion surrounding this item, including the cumulative rate factors for the East Branch Extension in the text prefacing the B-Tables. **We recommend that the Department update and publish Table B-1 and Table B-2 to include the East Branch Extension. This will provide the users of the B-Tables with the most beneficial information, as all of the relevant data will be located in one place.**

4) **The transportation variable charge per the SOC Attachment 4C for two of the three Contractors selected for testing by EY did not appear to be calculated correctly in the SOC.** Specifically, our calculated amount using the B-Tables for San Bernardino Valley's transportation variable charge for 2007 was 2,612 acre feet lower and $409,670 less than the amount shown in Attachment 4C. Additionally, our calculated amount using the B-Tables for Kern County Water Agency – Ag's transportation variable charge for 2005 was 19,164 acre feet higher and $151,827 higher than the amount shown in Attachment 4C. **Through discussions with the Department, we determined that the**

charges for San Bernardino were based on out-of-date information. The Department has indicated that it will correct this in the December 2008 re-bill. The Department was still in the process of investigating the Kern County Water Agency amounts; however, the Department stated that it will aim to resolve it prior to the December 2008 re-bill and include updated amounts at that time.

5) **We were unable to recalculate the transportation variable costs per Table B-12 for the reaches selected using SAP for all three of our selections in the current year.** The amounts pulled from SAP for the three reaches selected did not agree to Bulletin 132-08, Table B-12. We selected reach EBX2b for 2007, reach SB6 for 2006, and reach CA4 for 2005. The reach total for EBX2b was $66,646 higher in SAP than in Table B-12. The reach total for SB6 was $131,199 lower in SAP than in Table B-12. The reach total for CA4 was $1,744,051 lower in SAP than in Table B-12. **Through discussions with the Department, we determined that the calculations for Table B-12 were not performed within SAP for the 2009 SOC. We requested the supporting calculations for the reaches and years discussed above; however, we did not obtain them for testing prior to the conclusion of our 2008 testing. The Department has indicated that it will recalculate the Table B-12 costs using SAP for the December 2008 re-bill.**

6) **We were unable to recalculate the 2007 unit rate per Bulletin 132-08, Table B-17 for the Mojave Siphon Powerplant using Bulletin 132-08, Table B-6 and Table B-12, as the amount in Table B-6 is incorrect.** To obtain the unit rate factor, the water supply delivered per Table B-6 is divided by the variable cost per Table B-12. The unit rate we calculated for the Mojave Siphon Powerplant using these tables was $9.40. The unit rate per Table B-17 is $6.26. **Through discussions with the Department, we determined that the amount in Table B-6 is an estimate and has not been properly updated. The Department has indicated that this will be trued-up in Bulletin 132-09.**

Update of Prior Year Findings

2007 Finding:

During our 2007 testing, we were unable to verify that the minimum, capital and variable billings, as well as the unit rates (per Table B-17), were correct due to the delayed availability of the B-Tables.

2008 Update:

In 2008, we performed the 2007 testing we were unable to complete in the prior year and did not note any additional findings.

2007 Finding:

As part of our reach cost testing in 2007, we compared minimum costs recorded in SAP for Reach CA 29G for 2006 to the amount listed at Table B-11 of Bulletin 132-07. We were unable to recalculate the reach amount in 2007 using SAP data. The Department provided detail that showed the total was $5,098,582, which was different than the B-table amount of $4,585,284, resulting in what appeared to be an under-billing of $513,298.

2008 Update:

In 2008, we re-pulled the data from SAP and obtained a total of $5,122,521. This indicates that costs within SAP increased $23,939 over the past year for Reach CA 29G for 2006. We compared this amount to the Bulletin 132-08 value for Reach CA 29G for 2006, noting the amount in Table B-11 had increased to $5,130,725. This reflects a current under-billing of only $8,204 when compared to the current SAP figure. **We inquired as to the reason for the large increase in the amount from the Bulletin 132-07 data to the Bulletin 132-08 data. The Department was unable to provide the specific reason for the increase; however, the Department speculated that it was caused due to resolving issues that had resulted from the migration to the new SAP system.**

PROPORTIONAL USE FACTORS

General Background

PUFs are factors used for distributing reach capital costs and reach minimum OMP&R costs among the Contractors. The allocation of reimbursable capital costs and minimum OMP&R costs of each reach are based on the proportionate maximum use of that reach by respective Contractors under planned conditions of full project development.

Tables B-1 and B-2 in Bulletin 132 represent the percentage of cost from each reach that is allocated to each Contractor. The total of all allocations of Contractors is equal to 100%. This allocation is based on the distance the water must travel to each Contractor at full capacity, and theoretically, should not change from year to year.

<u>Procedures Performed</u>

Capital

- Compared Table B-1 from Bulletin 132-08 to Table B-1 from Bulletin 132-07.

- Tested Table B-14 for one Contractor on each aqueduct (North Bay, South Bay and California) by multiplying the total cost per reach (Table B-10) by the selected Contractor's PUFs for that reach (Table B-1).

Minimum

- Compared Table B-2 from Bulletin 132-08 to Table B-2 from Bulletin 132-07.

- Tested Table B-16A for one Contractor on each aqueduct (North Bay, South Bay and California) by multiplying the total cost per reach (Table B-11) by the selected Contractor's PUFs for that reach (Table B-2).

<u>Findings and Results</u>

After a review of Tables B-1 and B-2, we noted that there were not any reportable findings. We have included the following for informational purposes. During our recalculation of the transportation minimum costs at Table B-16A, we noted that $3 million is being included in the transportation minimum for BDCP costs. Additionally, costs for the MWQIs are being included in the transportation minimum. For details on the amounts by Contractor, see the Contractor's respective Attachment 8 and Attachment 9 to the SOC.

<u>MONTEREY AMENDMENT</u>

<u>General Background</u>

SWP drought and regulatory shortages during the 1987–1992 period prompted both Ag contractors and M&I contractors to consider amendments to their respective Contracts with DWR. Litigation to resolve differences over the water allocation provisions was considered by at least one of the Contractors. To avoid litigation and to make the SWP operate more effectively for all Contractors, the parties, including the Department, negotiated a package of principles in December 1994. These principles were meant to serve as a foundation to settle their disputes over water allocations and certain operational and financial aspects of the SWP. This foundation is established in "The Monterey Agreement – Statement of Principles," which was incorporated in a subsequent Contract amendment.

The Monterey Agreement is intended to be an "Integrated Package," and requires Contractor participation in all provisions. As of December 2008, 27 of the 29 Contractors have signed the Amendment (Empire West Side Irrigation District and Plumas County are currently the only non-signing Contractors).

Under the Monterey Amendment, beginning in 1997, excess revenues were to be returned to Contractors each year in the form of RMCs. It was originally projected that $40.5 million would be available to be returned for the years 2001 and forward. Recent analysis and amounts returned have shown that this estimate was too high. According to the Monterey Amendment, in years when the credits are less than $40.5 million, they are to be allocated on a 24.7% – 75.3% basis between the Ag and M&I contractors, respectively. Any reductions not made due to cash shortages are to be applied without interest when the funds become available.

General Operating Account

In July 1997, the Department transferred a total of $22.7 million into the general operating account (GOA) from various Central Valley Water Project System Revenue Bonds series reserve accounts in accordance with the provisions of the Monterey Amendment. According to the Monterey Amendment, these funds are to be used to pay obligations incurred by the State of the types described in Water Code sections 12937 (b) and in the event of emergency or cash flow shortages. Under Article 51(e), the GOA is reviewed every five years to ensure the funding level is adequate.

The following activity occurred in the GOA in 2004, 2005, 2006 and 2007.

	General Operating Account (in millions) Year Ended December 31			
	2004	**2005**	**2006**	**2007**
Beginning balance	$ 22.9	$ 23.3	$ 23.9	$ 24.9
SMIF interest	0.4	0.6	1.0	1.0
Funds borrowed*	–	–	–	(17.0)
Ending balance	$ 23.3	$ 23.9	$ 24.9	$ 8.9

* See discussion below.

As discussed in the prior year, due to the Department's cash flow shortage, the Department borrowed $17 million from the GOA in 2007. In order to verify that the $17 million had been returned, we obtained the GOA balance as of June 30, 2008, from the State Controller's Office (SCO) and SAP, noting the cash balance per both sources was $26.2 million. This represents the return of the $17 million and an additional $300 thousand in Surplus Money Investment Fund (SMIF) interest earnings from the fourth quarter of 2007 and the first quarter of 2008. The SMIF interest for the third quarter of 2008 was recorded as a receivable at June 30, 2008.

Agricultural Rate Management Trust Funds

Under the Monterey Amendment, Ag contractors make deposits into the Ag rate management fund annually based on the amount of their respective RMCs and are entitled to a distribution from the Ag rate management trust fund when they receive less than 100% of their annual contracted water entitlement. According to the trustee agreement with Bank of New York, the Department is to notify the trustee in writing by April 15 each year the percentage of each Ag contractor's annual entitlement allocated for that year. The Department is also required to notify the trustee in writing on or about January 1 each year the amount that each Ag contractor is required to deposit into each of their accounts based on the RMCs being provided.

Permanent Transfers

Under article 53 of the Monterey Amendment, Ag contractors may permanently transfer up to 130,000 acre-feet of their respective Table A amounts and aqueduct capacity to M&I contractors. Currently, 114,000 acre-feet of this capacity have been transferred.

Procedures Performed

- Updated our understanding of the permanent water transfers in effect as of November 2008.
- Confirmed the balance in the GOA as of June 30, 2008, with the SCO, and tested the June 30, 2008, reconciliations by agreeing the asset balance to SAP and the cash balance to the confirmation. We obtained explanations for all reconciling items greater than $10 thousand dollars.
- Pulled the December 31, 2007, cash balance in the GOA account from SAP and agreed it to the December 31, 2007, reconciliation, noting no reconciling items greater than $10 thousand.
- Tested the allocation of the 2008 RMCs to M&I contractors in accordance with instructions set forth in the Monterey Amendment.
- Obtained the trustee statements (from Bank of New York) for the Ag contractor's rate management trust funds for December 31, 2007, and June 30, 2008. Performed an interest reasonableness test for each of the trust funds, and reviewed the trust statements for reasonableness.
- Inquired as to whether or not any Ag contractors obtained funding from their Ag rate management trust fund, and whether or not the related funding was distributed in accordance with the terms in the Monterey Amendment.

Findings and Results

1) As of December 2008, the Department had not finalized the amount of the 2009 RMCs. **We recommend that the Department determine the RMC amount and related allocation in a more timely manner to ensure that the correct amounts are reflected**

in the Contractors' monthly bills and allow the Contractors time to plan for the amounts they will ultimately receive.

2) **The RMC allocation is prepared utilizing Table B-15 data, excluding the effect of permanent water transfers. However, Table B-15 presented in Bulletin 132 includes the effect of permanent water transfers. In order to provide the most meaningful information and allow the users of the B-Tables to recalculate the RMC allocation, we recommend that the Department present the B-Tables both pre- and post- water transfers.** We identified this item while recalculating the 2008 RMC allocation. We obtained support for Bulletin 132-04, Table B-15, excluding water transfers from the Department, as we were unable to re-create this information within SAP due to the modification of future cost projections. **The capability does not exist within SAP to go back and generate old versions of the B-Tables.** In order to validate the report, we met with the member of the Department who originally ran the report and observed the modification date on the original Word file, noting that it agreed to the run date within the Excel report we were using. In order to agree the data from the Excel report to the data in the allocation spreadsheet, we had to manually add the costs related to the Coastal Branch Extension and the East Branch Extension; see the following finding for additional detail on this item.

3) **The Coastal Branch Extension and East Branch Extension costs are calculated manually and then added into Table B-15.** As noted in the previous finding, we identified this item while recalculating the 2008 RMC allocation. **As such, we were unable to agree these amounts to SAP. We recommend that the Department work toward a solution that includes each component in calculating the B-Tables within SAP.**

4) **Adjustments were included in the 2008 RMC allocation for M&I Contractors to correct errors in the previous years' calculations; however, the rationale used to make the adjustments was not clearly documented.** We noted that adjustments had been made in the 2008 RMC allocation to correct Table B-4 and B-15 amounts used in the RMC allocation for M&I Contractors from 1997–2004. We obtained an understanding of the adjustments to determine if they were correct. However, the Department had not retained the documentation of the rationale originally used to perform the calculation. As a result, it required significant effort to understand the calculation. **We recommend that on a go-forward basis the Department retain detailed documentation supporting the calculation of adjustments to the RMC**

allocations. We reviewed the calculations used to determine the final adjustments and agree with the Department's result. The total impact of the adjustments by Contractor is shown below.

Contractor	Adjustments for Corrected Allocations Conservation [1]	Transportation [2]	Total [1] + [2]
Napa	$ 479	$ 2,273	$ 2,752
Solano	791	2,922	3,713
Zone 7	821	509	1,330
Alameda	751	610	1,361
Santa Clara	1,799	2,036	3,835
San Luis Obispo	479	2,200	2,679
Santa Barbara	1,181	23,254	24,435
KCWA	(1)	320	319
AVEK	2,494	3,000	5,494
Castaic Lake	–	–	–
Coachella	423	868	1,291
Crestline	106	277	383
Desert	697	1,430	2,127
Littlerock	42	53	95
Mojave	(19,204)	129,431	110,227
Palmdale	312	396	708
San Bernardino	1,910	7,531	9,441
San Gabriel	535	1,537	2,072
San Gorgonio	352	2,933	3,285
MWDSC	36,949	85,159	122,108
Ventura	277	572	849
Yuba	167	–	167
Butte	411	–	411
Plumas	–	–	–
M&I subtotal	$ 31,771	$ 267,311	$ 299,082

5) **The 2005 and 2006 RMC allocations were prepared using the incorrect B-Tables.** According to the Monterey Amendment Article 51 (f), recalculations should be done for the apportionment of RMCs among M&I contractors every five years starting in the year 2000. In addition, any Contractor may request a special re-set of the allocation at will. As such, starting in the 2005 SOC year, the apportionment should have been based on Bulletin 132-04 data. The Department did not update the 2005 or 2006 RMC allocations, and instead these were prepared using the Bulletin 132-99 data. The 2007 and 2008 RMC allocations correctly use the Bulletin 132-04 data to perform the allocation. **We recommend the Department continue to work with the Contractors**

to ensure the allocation methodology of the RMCs is in accordance with the Monterey Amendment. We also recommend any changes to the process outlined in the Monterey Amendment (such as continuing to use the allocation percentages based on Bulletin 132-99 rather than updating them to the Bulletin 132-04 data) be documented in writing and communicated/verified through a Notice to the Contractors. The next change will occur for the 2010 SOC. When the allocation for the 2010 RMCs is prepared, they should be based on the Bulletin 132-09 data. We have recalculated the effect of using the Bulletin 132-99 data on the 2005 and 2006 allocations. **We recommend that the Department reallocate these amounts to the appropriate Contractors in order to be in compliance with the Monterey Amendment.** See table below:

Contractor	2005 Difference	2006 Difference	Total Difference
Napa	$ (1,487)	$ (1,033)	$ (2,520)
Solano	(6,149)	(4,271)	(10,420)
Zone 7	29,706	20,628	50,334
Alameda	32,971	22,896	55,867
Santa Clara	129,683	90,058	219,741
San Luis Obispo	(32,382)	(22,488)	(54,870)
Santa Barbara	(197,967)	(137,480)	(335,447)
KCWA	8,865	6,157	15,022
AVEK	(4,487)	(3,115)	(7,602)
Castaic Lake	(4,061)	(2,820)	(6,881)
Coachella	(3,639)	(2,527)	(6,166)
Crestline	(1,200)	(834)	(2,034)
Desert	(6,003)	(4,169)	(10,172)
Littlerock	(104)	(72)	(176)
Mojave	(7,806)	(5,421)	(13,227)
Palmdale	(654)	(454)	(1,108)
San Bernardino	72,818	50,568	123,386
San Gabriel	(7,918)	(5,499)	(13,417)
San Gorgonio	153,050	106,285	259,335
MWDSC	(151,888)	(105,473)	(257,361)
Ventura	(1,297)	(901)	(2,198)
Yuba	–	–	–
Butte	–	–	–
Plumas	(51)	(35)	(86)
M&I Total	$ –	$ –	$ –

6) **There is a general lack of controls surrounding the Ag rate management trust funds.** We inquired of numerous Department personnel about the controls in place surrounding the Ag rate management trust funds. We were unable to determine if there has been an individual responsible for corresponding with the trustee as required by the trust agreement in recent years. We were also unable to determine if disbursements or deposits have been made in accordance with trust agreements in recent years. Through inquiry we determined that the Department does note the funded or underfunded status of the accounts, however, does not send notifications informing the Contractors as to the status. Through discussions with the trustee (Bank of New York), we determined that Tulare Lake, Dudley Ridge and Kings County received distributions during the period of July 1, 2007, to June 30, 2008. Through discussions with Kern County Water Agency, we determined that they are no longer utilizing the Bank of New York account and have invested their monies in the County of Kern's Treasury Pool. The representative at Kern Country Water Agency indicated that this investment was approved by the Investment Committee in the 1990s. The Department was aware that Kern County Water Agency was using an alternate trustee, however, was unaware of whom. **We recommend that the Department designate an individual that is familiar with the trustee agreements to monitor activity and account balances within these funds. The Department should also designate someone responsible for providing the trustees with the needed information to determine compliance with the terms and conditions of the Contract. Alternatively, if there is no longer a viable reason to maintain these funds, we recommend they be terminated through a Contract amendment.**

Update of Prior Year Finding

The permanent transfer of Table A water from Kern County Water Agency to the Mojave Water Agency and the Castaic Lake Water Agency requires adjustments to be made to the PUFs to reflect that the water will be traveling beyond the Kern County Water Agency. In connection with the transfer, Mojave Water Agency has agreed to pay all future adjustments in charges and credits of past costs related to the 25,000 AF. As discussed with Contractor representatives, the proposed 1998 Phase I amendment waived changing the allocation of charges to Mojave Water Agency. Before the implementation of SAP, the Department had no system in place to perform these transfers of costs. As a result, a manual adjustment to various water transfer parties SOCs were made each year to address the issue. The SAP system now allows for the transfer of the costs without a manual adjustment; however, the Department has not documented how the various transfers are accounted for, and as a result, there is no assurance that they were accounted for properly. As noted above, processing permanent transfers under the Monterey Amendment are expected to continue through December 31, 2011. As of November 2008, it was noted that there is approximately $17.5 million that needs to be returned to certain Contractors related to permanent water transfers. These funds were collected through Contractors paying for their share of downstream aqueduct capacity resulting from the permanent transfers of Table A water. As of December 2008, these funds have not been returned, as the Department is currently working to determine the proper allocation between affected Contractors. **We recommend that the Department and Contractors work through the appropriate committees to ensure that the processes of accounting for permanent transfers are properly performed in the new SAP system. The Contractors involved in the water transfers should continue to work with the Department to ensure they are fully informed of the financial impacts of the transfer.**

WATER SYSTEM REVENUE BOND SURCHARGE

General Background

The annual charges to recover the WSRB financing consist of two elements. The first element is the annual charge to the Contractors for repayment of capital costs of water system facilities at the PIR. The second component is the Contractors' share of the WSRB surcharge to be paid in lieu of a PIR adjustment. The surcharge is the difference between the repayment of the total annual capital costs of water system facilities at the PIR and the total annual financing costs of the WSRB. The surcharge is calculated annually as if the PIR were increased to the extent necessary to produce revenues from all Contractors sufficient to pay such differences for that year. In making this calculation, adjustments in the Contractors' transportation capital cost component charges for prior overpayments and underpayments are determined as if amortized over the remaining years of the project repayment period.

Procedures Performed

- Reviewed Article-50 – WSRB financing costs to obtain an understanding of the WSRB surcharge purpose.

- Obtained a schedule of all debt proceeds by bond series, including principal and interest and ensured the schedule was complete.

- Using the schedule of all debt proceeds, calculated the total amount to be charged in the 2009 SOC for the WSRB surcharge (approximately 51% of debt proceeds are funded through the WSRB Surcharge and 49% are funded through the transportation charge).

- Recalculated the allocation of the 2009 WSRB surcharge (Table B-22) based on historical allocation factors. Investigated significant differences.

Findings and Results

1) **The WSRB surcharge calculation is performed outside of the system and is based on historical factors and ratios, which the Department believes have not changed since the year they were developed.** We reviewed the allocation among Contractors and compared the percentages to prior years and did not note any changes in the methodology used.

2) **The WSRB surcharge for the 2009 SOC was calculated using estimated values for series AE, which resulted in a misstatement of the WSRB surcharge.** The Department has indicated that it will update these amounts to the actual figures in the December 2008 re-bill. Our calculation, based on October 2008 data obtained from the Department, projects an overall decrease to the WSRB surcharge of approximately $1.4 million.

STATEMENT OF CHARGES

General Background

The Department prepares the Contractors initial SOC on July 1 each year for the subsequent year (i.e., the 2009 SOC was prepared July 1, 2008). The initial SOC represents the estimates of total costs to be paid in the future year. If needed, an updated version of the SOC, known as the re-bill, is sent to the Contractors later in the same year (i.e., the re-bill for the 2009 SOC would be issued in November or December 2008 and later if necessary).

Procedures Performed

- Prepared a comparison of current year totals from the SOCs' summary pages with the totals from the summary pages of the prior year SOCs for all Contractors. Inquired as to the reason for any large or unusual changes.

- Haphazardly selected the following five Contractors to perform detailed procedures: Kern County Water Agency, Mojave Water Agency, Empire West Side Irrigation District, Alameda County Water District and Santa Barbara County Flood Control and Water Conservation District. Our selections are rotated each year in order to obtain proper coverage of all Contractors. For these five Contractors we performed the following:

  1) Agreed all amounts on the summary pages to applicable detail pages of the bill.

  2) Agreed the sum of the capital and minimum components of the DWC (per Attachment 1) to the Bulletin 132-08, Table B-21. Verified the extension of the two Delta Water Rates by the annual entitlement for the year in Bulletin 132-08, Table B-4.

  3) Agreed the minimum OMP&R component for OAP facilities per Attachment 1-1 to Bulletin 132-08, Table B-16B.

  4) Verified that the capital components (per Attachment 3) are calculated in accordance with the Contract by recalculating the capital components and agreeing the amounts to Attachment 4A, according to the appropriate method.

  5) For Attachments 4A, 4B and 4C:

     - Agreed payments received to prior year SOC.

     - Verified "current overpayment or underpayment" by selecting three years for each Contractor tested and subtracted payments received from the calculated component.

- Verified "annual difference capitalized" by multiplying the current over/underpayment by the respective present value factor for three haphazardly selected years for each Contractor.

- Verified that the adjusted component is the sum of the 2009 calculated component and the total of the annual difference capitalized.

6) For Attachment 4A (capital component of transportation):

   - Agreed the calculated component to Bulletin 132-08, Table B-15.

7) For Attachment 4B (minimum component of transportation):

   - Agreed the calculated component to Bulletin 132-08, Table B-16A.

   - Haphazardly selected five calculated components for each Contractor and verified to SAP.

8) For Attachment 4C (variable component of transportation):

   - Agreed "Annual Water Quantities Delivered" to Bulletin 132-08, Table B-5B.

   - Haphazardly selected five calculated components for each Contractor and verified to SAP.

   - Agreed the calculated component to Bulletin 132-08, Table B-18.

9) For Attachment 4D (amortization of the capital component of transportation):

   - Cross-referenced the capital component amounts with the amounts from the detailed testing at Attachment 4A.

   - Calculated the "Unit rate for amortizing difference" by dividing the capital cost component by remaining water deliveries.

   - Calculated the 2009 amortization by multiplying unit rate calculated above by the 2009 deliveries.

10) For Attachment 4E (adjustments of capital component of East Branch Enlargement transportation charges) and Attachment 4F (adjustments of minimum OMP&R cost component of East Branch Enlargement transportation charges):

- Agreed payments received to prior year SOC.

- Verified "current overpayment or underpayment" by selecting three years for each Contractor and subtracting payments received from the calculated component.

- Agreed the calculated components to Bulletin 132-08, Table B-29 for Attachment 4E and Table B-30 for Attachment 4F.

- Verified "annual difference capitalized" by multiplying the current over/underpayments by the respective compounding SMIF rate.

- Verified that the adjusted component is the sum of the 2009 calculated component and the total of the annual difference capitalized.

11) Cross-referenced acre-feet, calculated component and annual difference capitalized from Attachment 5 to the detailed testing at Attachment 4C.

12) Tested the BDCP charges added to the Contractors' minimum components by recalculating the amounts based on Table A entitlements.

Findings and Results

1) **The acre-feet amounts per Attachment 1 for Kern County Water Agency – Ag and Kern County Water Agency – M&I do not agree to the 2009 amount per Bulletin 132-08, Table B-4.** However, the total of the two do agree to the 2009 total of the two per Bulletin 132-08, Table B-4. Through discussions with the Department, we determined that this was due to an error when printing the SOC. As such, our recalculations using those amounts did not agree to the 2009 amount per Bulletin 132-08, Table B-21**. These amounts are for informational purposes only and do not affect actual charges. The actual charges are picked up from Attachment 1, including both Ag and M&I charges. We recommend that the amounts be corrected on the**

re-bill in order to provide Kern County Water Agency with accurate data. We re-performed the calculations of the 2009 amounts for Kern County Water Agency – Ag and Kern County Water Agency – M&I per Bulletin 132-08, Table B-21 using the Bulletin 132-08, Table B-4 amounts and the allocation factor per Attachment 1 of the SOC, noting no differences.

2) **The 1993–2009 calculated component amounts per Attachment 4A of Santa Barbara County Flood Control and Water Conservation District did not agree to Bulletin 132-08, Table B-15.** This is due to the fact that the Bulletin 132-08, Table B-15 does not include charges related to the East Branch and Coastal Branch Extensions. We obtained a schedule combining the capital charges and East Branch and Coastal Branch Extension charges and were able to agree the SOC amounts to that schedule. **We recommend that this schedule, or a similar one showing the combination of charges, be included as part of the B-Tables, which are provided to the Contractors so that they can determine if their charges are correct.**

3) **The 2001 and 2006 calculated component amounts per Attachment 4B for Kern County Water Agency – Ag did not agree to SAP as SAP does not include relinquished capacity.** For the 2006 amount, we were able to subtract the relinquished capacity shown on the 2006 SOC from the SAP total and agree that amount to the 2009 SOC. For 2001, we obtained a separate schedule showing charges associated with the 45,000 acre-feet relinquished by Kern County and Dudley Ridge. Using this schedule, we subtracted the relinquished amount for 2001 from the SAP total and agreed that total to the 2009 SOC. (We did not perform detail testing of this schedule). **We recommend that the Department include this and all similar schedules showing charges associated with relinquished capacity as a supplement to the B-Tables.**

4) **We identified seven instances (two each from Kern County Water Agency – M&I, Kern County Water Agency – Ag, and Santa Barbara County Flood Control and Water Conservation District and one from Mojave Water Agency) in which the "Annual Quantities Delivered or Requested" per Attachment 4C did not agree to Bulletin 132-08, Table B-5B.** Through discussions with the Department, we determined the quantities shown on the SOC were not updated for the current year. However, we noted the correct quantities were used in calculating the calculated components. Therefore, there was no effect on the overall charges. **Although there was no effect on the amount billed because the correct deliveries were used in calculating the**

calculated components, it is our recommendation that the attachments be updated to show the correct annual quantities delivered.

5) **We identified seven instances (one from Mojave Water Agency, one from Alameda County Water District and five from Kern County Water Agency – Ag) where the "Annual Quantities Delivered or Requested" did not agree to Bulletin 132-08, Table B-5B (which does not take water credits into account).** These amounts did agree to an offline schedule showing annual quantities with water credits. This schedule is provided to the Contractors when requested but is not formally available. **We recommend that this schedule be published in some format (e.g., as an appendix, additional table, etc.) in conjunction with the B-Tables.**

6) **Eighteen of the 30 calculated component amounts we selected for testing from Attachment 4C did not agree to SAP.** We noted that for all the Contractors tested (Alameda County Water District, Empire West Side Irrigation District, Kern County Water Agency, Mojave Water Agency and Santa Barbara County Flood Control and Water Conservation District) several of the calculated component amounts that we haphazardly selected from Attachment 4C did not agree to SAP. Specifically, the years and amounts were as follows:

Mojave Water Agency

- 2007 SAP amount was $6,038,148, Attachment 4C amount was $6,557,076

Kern County Water Agency – Ag

- 1971 SAP amount was $731,754, Attachment 4C amount was $769,054
- 1984 SAP amount was $1,895,945, Attachment 4C amount was $1,996,259
- 2002 SAP amount was $7,296,998, Attachment 4C amount was $7,493,178
- 2007 SAP amount was $10,416,174, Attachment 4C amount was $12,038,199

Kern County Water Agency – M&I

- 1974 SAP amount was $45,531, Attachment 4C amount was $46,752
- 1982 SAP amount was $138,432, Attachment 4C amount was $145,246
- 1997 SAP amount was $557,650, Attachment 4C amount was $650,416
- 2004 SAP amount was $1,368,607, Attachment 4C amount was $1,390,386
- 2007 SAP amount was $651,650, Attachment 4C amount was $1,438,394

Empire West Side Irrigation District

- 1989 SAP amount was $15,047, Attachment 4C amount was $15,450
- 1998 SAP amount was ($55), Attachment 4C amount was ($28)
- 2006 SAP amount was $31,916, Attachment 4C amount was $34,020

Alameda County Water District

- 2001 SAP amount was $991,474, Attachment 4C amount was $997,070

Santa Barbara County Flood Control and Water Conservation District

- 1998 SAP amount was ($89,207), Attachment 4C amount was ($82,727)
- 2000 SAP amount was $440,637, Attachment 4C amount was $440,747
- 2003 SAP amount was $1,696,507, Attachment 4C amount was $1,709,803
- 2007 SAP amount was $2,586,097, Attachment 4C amount was $2,513,392

The Department had not provided a response as to why these amounts did not agree to SAP as of December 2008.

7) **The payments received for 2003 and 2004 per Mojave Water Agency's Attachment 4E changed from the prior year SOC.** We were unable to obtain an explanation of these variances from the Department.

8) **The Department did not use the most current B-Tables in the 2008 allocation of BDCP charges.** As part of our testing of BDCP charges, we noted that the Department used Bulletin 132-07, Table B-4 amounts in its calculations instead of the Bulletin 132-08 amounts. Only one Contractor's entitlements changed from 2007 to 2008; however, as the charges were based on what portion of the total each Contractor receives, this difference affects the charges for every Contractor. We recalculated the charges using the Bulletin 132-08 amounts. The largest resulting difference was less than $4,000. **We recommend that the Department use the most current amounts in its calculations and update these calculations as new information becomes available.**

9) **MWQI charges were added manually to the 2008 and 2009 SAP minimum component totals.** However, these charges, totaling $3.1 million in 2008 and $3 million in 2009 had previously been entered into SAP and were thus being included twice in the minimum component. **The Department has indicated that it will correct this in the re-bill.**

The following has been included for informational purposes and was identified through our SOC testing:

Through our testing of the BDCP charges, we noted that the allocation for Yuba City and Butte County was not included in the transportation minimum (as the transportation minimum component does not apply to these Contractors), but instead was added to the minimum DWC.

NEW AND CHANGED COST AND FUND CENTERS

General Background

The purpose and use of fund and cost centers as well as the procedures surrounding these items are detailed in EPGs published by the Department for internal use. We used these guides in addition to our discussion with the FOSO personnel to further our understanding of these subjects.

The EPGs outline the required course of action for creating a fund or cost center, which includes a program manager filling out a request form that is subsequently reviewed and approved by an administrative officer. Once this approval has taken place, the form is sent to either the budget office or the FOSO (if funded by SWP) and a help desk ticket is created. Forms sent to the budget office are reviewed, approved and forwarded to the FOSO. Once received by the FOSO, both the help desk ticket and request form are reviewed for completeness and the new fund or cost center is created and added into SAP.

Procedures Performed

- Updated our understanding of the processes in place surrounding cost and fund centers.
- Obtained a listing of all new and changed cost and fund centers for the period from January 1, 2007, to December 31, 2007.
- Selected 25 entries and tested for proper approval.

Findings and Results

The Department is not consistently following the procedures required to create or update cost and fund centers. We tested 25 new and changed cost centers created in 2007 and noted only five were created in accordance with the required methodology. **The Department plans to update the EPGs to create exceptions to the requirements to obtain approval. Nevertheless, we recommend that FOSO ensure all approval forms are appropriately completed for any circumstances where exceptions are not stipulated.**

KB-15 ENTRIES

General Background

KB-15 entries are used to move out of period power costs to the correct period. Manual KB-15 entries are currently made for items such as wheeling credits, rental income, PALPOC adjustments and USBR payments. A monthly reconciliation is made by the Department to ensure proper posting. All other entries are automatically posted in SAP to the correct period based on the invoice date.

Procedures Performed

- Updated our understanding of the process with Department personnel, ensuring no significant changes have been made.
- Obtained a listing of all 2007 KB-15 entries from the Department. Re-pulled the data from SAP to ensure it was a complete sample.
- Randomly selected 25 entries to test from all entries over $25,000 made during the year.
- Obtained supporting documentation for each entry to ensure the entry had been posted to the appropriate period.

Findings and Results

In the current year, we had difficulty obtaining a complete listing of KB-15 entries. This was primarily due to turnover of Department personnel. We have historically asked for this report as part of our annual procedures and have not had difficulty acquiring it. However, the Department employee who has provided the report in the prior years was unavailable to assist with this year's procedures. In order to minimize this difficulty in future years as well as to prevent other situations in which there is confusion about pulling a report, **we recommend that the Department create standard procedures for pulling the KB-15 entries and any other**

processes deemed necessary. We were ultimately able to obtain this listing in November 2008 and completed our testing noting no additional findings.

PROJECT INTEREST RATE

General Background

According to the standard provisions for the Contract, the PIR "shall mean the weighted average of the interest rates paid by the State on bonds under the Bond Act without regard to any premiums received on the sale thereof. Until bonds are issued and sold under the Bond Act, the PIR shall be four percent (4%) per annum, and after said bonds have been issued said rate shall be computed as a decimal fraction to five places."

Since 1998, the bonds issued that affected the PIR are series U, W, AD and AE. The other series issued since that time have not affected the PIR as they relate to projects that are not covered by the Bond Act. Currently the PIR is 4.608%.

The PIR is primarily used by the Department for all transportation and conservation calculations in order to determine the present value of water and money.

Procedures Performed

- Obtained the calculation and supporting material for the PIR to be used in the 2009 bills.
- Agreed the beginning PIR to the rate from the prior year.
- Updated our understanding of what types of things could cause an adjustment to the PIR, whether anything of the sort has recently occurred and whether any adjustments are anticipated in the near future.
- Obtained the Official Statements of all new bond issues occurring since December 31, 2006.

Findings and Results

There were no reportable findings as a result of our procedures performed on the PIR. We were able to agree amounts used in the calculation back to all supporting material. We conclude that the PIR is reasonable based on these amounts. We noted that while series AE affected the PIR, it did not change the amount enough to affect the rate computed as a decimal fraction to five decimal places.

INTERNAL AUDIT

General Background

During 2008, Internal Audit issued two reports, the internal control review and the review of the Department's UNIX server security. The report on internal controls is a biannual report that adheres to requirements and objectives of the State Administrative Manual, Chapter 20,000. Per review of their report, we noted that Internal Audit's procedures consider DOF guidance and are in accordance with professional standards.

Procedures Performed

- Obtained all Internal Audit reports issued since our last report date.

- Met with Internal Audit personnel and discussed areas with which Internal Audit was involved during 2007 and 2008 and any other areas where procedures are planned for 2008.

- Summarized any items related to the scope of our report or that we believe could be of importance to the Contractors.

Findings and Results

Through our review of the report on internal controls, we noted weaknesses in the Department's cash receipts, revolving fund, cash disbursements, receivables, purchases, fixed assets, financial statement and personnel processes, which could affect the accuracy of the Contractors' bills.

Noteworthy findings are summarized below:

- The personnel responsible for receiving checks do not always forward these checks to the cash receipts sections in a timely manner. Additionally, the field offices do not always deposit checks in a timely manner with the State Treasurer's Office per the policy. As a result, interest income is lost.

- There is a lack of separation of duties within the purchasing process.

- There is a lack of separation of duties within the SAP human resource processes.

- Within the last three years (as of the Internal Audit report date), there had not been a department-wide fixed asset inventory completed. This could result in inaccurate fixed asset accounting data.

The Department responded to these findings, and their responses were included in the Internal Audit report. We noted the Department had developed plans to correct some of the issues regarding separation of duties within both the purchasing and SAP human resources processes. Additionally, the Department is working on scheduling a department-wide fixed asset inventory.

Through our review of the Internal Audit report on the UNIX server security, we noted that the Department does not appear to have proper security controls in place over who has access to the server. Additionally, management has not properly tested backups or identified proper ways to store, protect and restore these backups. Per review of the Department's responses included with the report, we noted it was working to correct these control weaknesses.

We recommend that the Department follow the Internal Audit recommendations for internal controls and continually review its processes to ensure controls are in place and functioning properly.

REPLACEMENT ACCOUNTING SYSTEM

General Background

Transportation Facility Replacements

Under the PAYGO system, transportation facility-related replacement costs are collected through the variable OMP&R component of the transportation charge. For billing purposes, beginning with the 1999 SOC, estimated replacement costs, along with all other O&M costs, are provided to the Department by the Division of O&M. Transportation estimates include state operations and direct pay expenditures. These estimates are updated once actual costs are known. Transportation costs are then allocated to the Contractors based on those Contractors that had water go through the plant containing the transportation facility equipment during the wear-out period. An analysis of this allocation is prepared by the Department to ensure that only the Contractors who wore out the component are charged for its replacement. The Contractors' annual SOCs include the estimated replacement costs for the bill year along with an over/under-adjustment to prior year estimates, bringing these amounts to the actual costs. The 2009 SOC included $6.9 million of estimated 2009 charges and an under-bill adjustment of $1.5 million from prior year estimates.

The following charts replacement costs included in the 2009 SOC versus the amount allocated:

Year	Calculated Replacement Component	Collected Replacement Payments	Amount Over/(Under) Collected	(Over)/Under Collected with Interest	Net Interest Effect
1999	2,915,118	4,095,580	(1,180,462)	(1,852,256)	671,794
2000	2,249,706	1,496,416	753,290	1,129,916	(376,626)
2001	596,934	4,121,386	(3,524,452)	(5,053,716)	1,529,264
2002	2,401,355	700,585	1,700,770	2,331,309	(630,539)
2003	1,629,442	(2,665,642)	4,295,084	5,628,090	(1,333,006)
2004	1,972,143	6,135,119	(4,162,976)	(5,214,689)	1,051,713
2005	4,733,533	31,221	4,702,312	5,630,812	(928,500)
2006	4,684,691	3,268,849	1,415,842	1,620,726	(204,884)
2007	4,105,370	1,867,500	2,237,870	2,448,864	(210,994)
2008	9,248,027	14,144,318	(4,896,291)	(5,121,912)	225,621
	34,536,319	33,195,332	1,340,987	1,547,144	(206,157)

The following is a summary of the estimated transportation replacement costs included in the 2009 SOC:

Calculated component for 2009	$6,908,069
Prior year (over)/under-adjustment without interest effect	(1,340,987)
2009 transportation replacement charges	5,567,082
Net interest effect on prior year (over)/under-adjustment	206,157
Net 2009 transportation replacement charges reflected in the SOC	$5,773,239

Conservation Facility Replacements

Under the PAYGO system, conservation replacements were to be initially funded by a $9 million conservation replacement account. From the adoption of RAS PAYGO in fiscal year 2000 through 2003, the Department funded conservation replacements from the WRRF, which was then replenished by the replacements fund. In the 2005 SOC issued in July 2004, the Department included $5.5 million in the DWC for estimated conservation replacements, resulting in an increase to the DWC of $1.33 per acre-foot. In the 2006 SOC, the Department included $8.7 million in the DWC for estimated conservation replacements, resulting in an increase to the DWC of $2.08 per acre-foot. There were no costs for conservation replacements included in the 2007 through 2009 SOCs.

Replacement Reserve

The RAS reserve fund is used to cover fluctuations in transportation and conservation replacement payments and timing differences for Contractor payments. It is used to pay for replacement expenditures and is funded by Contractor payments based on estimates adjusted for over/under-collections from the systems revenue account. The fund earns interest at the current SMIF rate.

A portion of existing transportation monies in the RAS reserve funds was used as the initial PAYGO replacement reserve fund (separate from the $9 million PAYGO conservation fund previously discussed). The adequacy of the PAYGO reserve fund should be assessed annually by March 1 through joint meetings of the Department and Contractor representatives.

The following is a summary of the activity in the replacement reserve accounts according to the SCO for the period from June 30, 2007, through June 30, 2008 (in thousands):

Balance at June 30, 2007	$ 30,191
Adjustments	(23,651)
Deposits and associated interest	6,181
Balance at June 30, 2008	$ 12,721

Procedures Performed

Transportation Facility Replacements

- Prepared a "Transportation Replacement Component" account summary for all Contractors using the 2009 SOC.

- Obtained the Bulletin 132-08 budgeted replacement cost schedule from the Division of O&M (this was the schedule used by the Department to calculate the replacement costs in the 2009 SOC).

- Compared the descriptions of the items included in the budgeted replacement cost schedule to the "Master Replacement Listing" to determine the appropriateness of the classification as a replacement.

- Obtained the 2009 water through plant allocation prepared by the Department and tested to verify the allocation of costs is in accordance with PAYGO. The allocation rate is based on whether the equipment being replaced is stationary or rotating. We compared the classification of the equipment per the 2009 water through plant allocation to the budgeted replacement cost listing and determined whether the equipment was stationary or rotating based on the item description.

- Obtained the analysis relating to the "Prior Years RAS Over and Under Adjustments."

Replacement Reserve Fund

- Using the SCO fund reconciliation reports for the current year, performed the following:

    - Confirmed the replacement fund balances with the SCO as of June 30, 2008. Agreed the confirmed amount back to the monthly activity analysis prepared below.

    - Summarized the monthly activity through the most recent fiscal year-end included in the SCO fund reconciliation reports.

- Tied the fiscal year-end balances to the balances per the SCO fund reconciliation reports and traced any additional activity from SAP into the SCO fund reconciliation reports.

  For all withdrawals, including RAS refunds, ensured that the withdrawal was in accordance with the current RAS methodology. For any credits or refunds from the funds, obtained supporting information from Fiscal and tested as appropriate.

  Obtained the SMIF interest rates for the calendar year 2007 and through July 2008 and verified the reasonableness of SMIF interest earnings of the RAS funds for fiscal year 2007.

Findings and Results

General

1) In the current year, the Department expressed that there had been changes to the PAYGO process. However, it did not comply with our request for information regarding the nature of these changes.

2) The meeting to assess the reserve balance was intended to occur annually beginning in 2001; however, this meeting has not taken place in recent years.

Transportation Facility Replacements

1) **The acre-feet quantity in the water through plant allocation did not agree to Bulletin 132-08, Table B-5B for three out of five of the Contractors selected**. The water through plant allocation shows the acre-feet quantity attributed to each Contractor that represents the total amount of water pumped through the listed pumping plant for that contractor over the last 30 years for rotating equipment and over the last 20 years for stationary equipment. To test the quantities attributed, we haphazardly selected five Contractors to agree their acre-feet quantity to Table B-5B. Out of these five, we discovered three Contractors (Antelope Valley–East Kern County Water Agency, San Bernardino Valley Water District and Mojave Water Agency) whose acre-feet quantities did not agree to Table B 5B. **Although the correct total was billed by the Department, this**

error resulted in misallocation of the costs to the Contractors. Through discussions with the Department we determined this inaccuracy was due to a processing error in SAP (SAP had picked up the wrong amounts). After discussion of this matter with the Department, we learned that a similar error had occurred shortly after the conversion to SAP. **As the bills are generated by amounts pulled from SAP, this issue raises questions as to the accuracy of other amounts pulled from this system. The Department has indicated that it will correct the allocation in the December re-bill.**

2) **The rotating rate was incorrectly used to calculate the replacement cost of stationary equipment at the Chrisman plant.** Whether the water quantities from the past 20 years or the past 30 years are used is based on whether the equipment being replaced is stationary or rotating. When comparing the allocation rates to the equipment being replaced per the budgeted replacement cost listing, we discovered that for the Chrisman plant the rotating rate was used, although the equipment being replaced was stationary. Although this did not have a large impact on any one Contractor (the largest impact was $1,047), the Department should implement sufficient controls to catch this type of error. **The Department indicated that the correction for this error will be made when actual costs are determined and allocated. However, as the Department resolved to correct the error discussed in the previous finding at the time of the re-bill, we recommend that this error be corrected at that time as well in order to present the most accurate estimation of costs.**

3) **Replacement charges in Attachment 5 of the SOC were reversed for Alameda County Flood Control & Water Conservation District Zone 7 and Alameda County Water District, and Kern County Water Agency – Ag and Kern County Water Agency – M&I.** After completing our assessment of the Department's water through plant allocation as discussed above, we summed the total costs for each Contractor and compared those amounts to the estimated RAS charges listed in Attachment 5 to the SOC. We determined that the amounts for Alameda County Flood Control & Water Conservation District Zone 7 and Alameda County Water District were incorrectly reversed on the SOC. We also determined that amounts for Kern County Water Agency – Ag and Kern County Water Agency – M&I were also reversed. This did not have a large monetary impact on any of the Contractor's bills; however, this error should be corrected to

present accurate information. **The Department has indicated that it will correct these errors in the December re-bill. We recommend that the Department implement internal controls that would identify this type of error in the future.**

The following has been included for informational purposes and was identified through our testing of replacements.

The Master Replacement Listing has not been updated in recent years. The Department plans to update this listing with all current information by January 2009.

Conservation Facility Replacements

1) **The conservation fund does not accurately reflect the $5 million that was collected to replenish it.** During our process of reconciling the SCO fund balance to SAP activity for fiscal year 2008, using the RAS reconciliation prepared by Fiscal, we became aware that the conservation fund needs replenishment.

This issue stems from the Hyatt refurbishment which started in 2000. At the time, it was thought that the project would merely consist of replacements, thus the sinking fund was used for funding. The Department estimates that roughly $8 million was used from the sinking fund from 2000–2003. In 2003, it was determined that there was not enough left in the sinking fund to continue funding the project. Consequently, Contractors were billed through RAS charges in proportion to Table A Entitlements. For 2003–2006, approximately $24 million was collected from the Contractors to fund the Hyatt refurbishment with another $3.4 million collected in interest. In 2006, it was decided to return what had been collected up to that point (including the original $8 million from the sinking fund) through credits to the Contractors and fund the Hyatt refurbishment in a different manner. In 2007, the total credits given to the Contractors were approximately $35 million.

The necessary funding is now being collected in two ways. For Units 2, 4 and 6, bonds were issued in May 2008. The Department is currently working on determining the portion related to conservation replacements. Once this is determined, that amount will replenish the conservation fund. Current expenditures for these Units are tracked through the capital component, which is offset by the bond proceeds.

For Units 1, 3 and 5, the Contractors were billed approximately $20 million through the transportation variable component. This $20 million included the interest that was given back to the Contractors as part of the $35 million in credits. A portion of this amount, roughly $5 million, will be used to replenish the conservation fund. Currently, this replenishment has not taken place. This was discovered during our testing of the RAS reconciliation. Through our procedures, we determined that this issue had gone unresolved for a long period due to a lack of communication between divisions of the Department. Our conversations with the Department led to discussions between divisions about the course of action needed to replenish the conservation fund. The Department is currently determining how to resolve this issue.

The Department was not certain of the timeline as to when the conservation fund would be replenished, but speculated that it would take place during the next fiscal year. **We recommend that the Department work to properly account for the conservation fund as soon as possible and reevaluate the need for the fund. In addition, we recommend that the Department coordinate between internal departments more effectively so that situations such as this are not overlooked and unresolved.**

SYSTEM POWER COSTS

General Background

Since 1983, SWPAO has been responsible for the administration of power contracts (sales and purchases) and the computation of the variable and minimum transportation and off-aqueduct components of the Contractors' bills. Accordingly, SWPAO maintains detailed data support including invoices for all power transactions. SWPAO performs a monthly reconciliation between the data collected by the JOC and the SWPAO data to ensure everything is being accounted for.

A summary of power costs and revenues for each year, including costs assigned to the value of recovery generation and energy transmission, is prepared by SWPAO and presented in a memorandum entitled "Preliminary Allocation of Power Costs" (PALPOC). Some of the costs included in the PALPOCs are estimated and subject to continual revision. Once the costs for a year are finalized, a "Final Allocation of Power Costs" (FALPOC) is issued.

The Department currently has a methodology in place to bill for power that eliminates many of the large discrepancies noted in the past EY reports and more closely approximates actual costs incurred; however, it still avoids correction of the fundamental system weakness: the inability of the Department's accounting system to accurately accumulate power costs and revenues and hence, the reliance on amounts accumulated by non-accounting personnel in a separate system, which is largely void of checks and balances. Historically, the data maintained by SWPAO is more accurate than the accounting information. In 2000, SWPAO began providing the accounting department copies of all power-related invoices pre-coded and approved for processing. The accounting personnel prepare reconciliations of the SAP information to SWPAO power history, which is maintained outside SAP.

Transmission costs are billed to the Contractors primarily through the variable component of OMP&R. Previously, transmission costs had been billed through the minimum component of OMP&R. This billing change occurred at the end of 2004, when power transmission contracts with Southern California Edison (SCE) and Pacific Gas and Electric (PG&E) (the electrical high voltage contract) expired. During the period when the contracts were in place, transmission costs were fixed per the contract terms. Therefore, Contractors were billed through the minimum component.

After the contracts expired, DWR obtained power transmission in the open market through CAL-ISO and PG&E. Power transmission is now variably charged to DWR using a load-based allocation rate. Because power transmission costs are now variable in nature for DWR, the Department is now appropriately billing Contractors through the variable OMP&R.

Procedures Performed

- Updated our understanding of the process being used to track costs and revenues and prepare the PALPOCs.

- Requested copies of any FALPOCs finalized during the year.

- Obtained the spreadsheet of power costs and revenues compiled at the JOC for the 2007 calendar year, tested the clerical accuracy, vouched all amounts greater than $100 thousand to vendor invoices for power purchases and reviewed Department support for power revenues (power sold to external parties).

- Obtained the 2007 calendar year Table 1 – Net Pumping Cost Summary, Table 2 – Energy Costs and Table 8 – Energy Revenue, tested the clerical accuracy and cross-referenced the amounts to the data obtained from the JOC. Additionally, we cross-referenced the amounts from Table 1 to Tables 5 and 8.

- Obtained the 2007 PALPOC, tested it for clerical accuracy and cross-referenced the amounts to Table 1, Table 2 and Table 8.

- Obtained the 2007 calendar year PALPOC to SAP reconciliation of power costs and power revenues, tested it for clerical accuracy and cross-referenced the Utility Cost Accounting and Billing System (UCABS) amounts to SAP and the PALPOC amounts to the 2007 PALPOC. We investigated all significant differences between the reconciliation and SAP, and the reconciliation and the PALPOC. We investigated all reconciling items greater than $100 thousand.

<u>Findings and Results</u>

1) **The process used to accumulate power revenues and expenses for inclusion in the SOCs is manual and requires a significant amount of time and effort. This results in delays of information and a higher potential for errors.** Currently, Fiscal enters the power information into SAP. Additionally, the JOC maintains a spreadsheet detailing out the power revenues and expenditures for each year. There is often a cut-off issue between the JOC information and the SAP information, as the JOC and Fiscal receive invoices at different times. SWPAO takes the information from SAP and the information from the JOC and combines them to prepare Table 2, which is used to create the PALPOC. Through discussions with various personnel at the Department, we determined each department strives to keep the other departments appropriately informed and up-to-date. **However, as exemplified by several of our findings, the number of parties involved in the process increases the potential for errors**.

2) In 2004, in connection with the implementation of Phase IIB, the Department, in consultation with the Contractors' consultants and auditors, performed the scoping of the reporting phase of the project. The resulting report included redesigning the accounting process over power revenues and expenses. This was expected to eliminate many of the

redundant activities that are currently performed by SWPAO and the accounting department. In addition, it was expected to provide for more timely accurate power billing information that would eliminate inaccuracies and large adjustments that were previously experienced. The PCD went live in September 2005; however, due to the SAP upgrade and an additional delay due to a transition to Cognos reports, the Department has not begun using PCD. PCD is a tool used for the power cost allocation charges intended to automate the calculations for power costs that are currently manual. **As of December 2008, the Department has not begun using PCD to generate the FALPOCs.**

3) **The 1999–2007 FALPOCs have not been completed**. During the course of our power revenue/expense testing, we noted that the Department issues multiple PALPOCs before issuing its FALPOC. Additionally, the period of time between the issuances of the PALPOC and FALPOC is not timely (generally, it is greater than five years). **We recommend that the Department work to issue the FALPOCs within a more reasonable time period. A possible option would be to issue additional billings or refunds based on the preliminary allocation, similar to the process used for OAP. The FALPOCs generally result in either an additional billing or a refund to Contractors, and the delay in finalization could result in cash flow issues for the Department or deprive Contractors of use of any funds being returned.** Through discussions with the Department, we determined it generally takes three years from the issuance of the first version of a year's PALPOC for all invoices for that year to be received and reflected.

4) **The JOC recorded power expenses totaling $142,670 related to a CAL-ISO contract that were not included in SWPAO Table 5.** These are annual fees for the North American Electricity Reliability Corporation (NERC) and the Western Electricity Coordinating Council (WECC). In the past, these fees were invoiced by and paid directly to the two respective organizations. Starting in 2008, CAL-ISO began collecting these fees on behalf of the two organizations. As a result, Fiscal was notified that these fees should henceforth be paid through the CAL-ISO account. These fees were previously funded from a separate account that does not flow into the calculation of net pumping power costs. At the time Table 5 and the corresponding 2007 PALPOC was prepared, SWPAO was not aware that these costs were now being paid out of the CAL-ISO account. Subsequent to our inquiry of SWPAO regarding the NERC/WECC fees, it was determined that these fees should be included in the calculation of net pumping power

costs, as they are now part of billings from CAL-ISO. As a result, the CAL-ISO charges detailed in Tables 5 and 2 have been updated to include the NERC/WECC fees. **Although the fees were ultimately reassessed for inclusion, the circumstances detailed above exemplify the potential for errors within the current process, where multiple sets of data are kept by separate departments. The JOC did communicate the new treatment of NERC/WECC fees with Fiscal. However, not all parties involved in the power process were made aware of these new developments. We encourage JOC, SWPAO and Fiscal to improve their degree of interdepartmental communication.**

5) **A distribution of $121,161 from the Enron bankruptcy settlement was excluded from the current version of the 2000 FALPOC.** Through our testing of the PALPOC to SAP reconciliation, we noted that the Department received $121,161 as a distribution from the Enron bankruptcy settlement. Consistent with our understanding from prior years, the Department had initiated litigation against Enron to collect on revenue from 2000 and 2001. Although litigation was underway, the Department had concluded that there was no potential for collecting the owed amounts. As a result, the Department decided not to include Enron revenue amounts in the 2000 FALPOC. **As the Department received this distribution, and the 2000 FALPOC has not been finalized, we recommend that the 2000 FALPOC be updated to reflect the $121,161 Enron distribution.**

6) Through our testing of the PALPOC to SAP reconciliation, we noted that SWPAO listed December 2007 NPC revenues totaling $1,351,989, while SAP recorded only $301,786. Additionally, SWPAO listed NPC revenue for June 2007 of $2,911,464, while SAP recorded $2,930,981. The December variance was due to a December refund posted to SAP but not captured by SWPAO. This entry was posted to SAP on March 28, 2008. **As the PALPOC was completed on April 3, 2008, it is reasonable that SWPAO would not have been aware of the refund in time to update Table 8 and the corresponding PALPOC.** The June variance was due to revenue that was mistakenly omitted from the PALPOC. We inquired as to whether the PALPOC had been updated to reflect these changes. The PALPOC was updated September 29, 2008, to include the changes in NPC revenues.

7) **CAL-ISO variable transmission costs per the PALPOC did not agree to CAL-ISO variable transmission costs per SAP or Table 5.** When reviewing the PALPOC to

SAP reconciliation, we noted that the variable transmission costs per attachment B to the PALPOC were $27 million, while the amount in SAP and Table 5 was $30 million. As discussed in Finding #3, the Department drafts several versions of the PALPOC. We inquired as to whether the PALPOC had been updated to reflect the amount in SAP and Table 5. We determined that the figures were updated in the September 29, 2008, version of the PALPOC to $29 million. We obtained the October 31, 2008, version of Table 5, noting that it also reflected the updated amount of $29 million.

8) **Costs of $804 thousand related to 2008 were incorrectly included in the 2007 PALPOC, creating a cutoff issue, which results in incorrect costs in the PALPOC**. Through our detail testing of power purchases, we noted an invoice for $803,752 was recorded as a 2007 cost, but related to the period of January to March 2008. Through inquiry of the Department, we determined this invoice was paid in December 2007. Per the Department, this December payment has consistently been allocated to the year in which it was paid and not the service period to which it relates. There have been internal discussions on the appropriate allocation, and it was decided to allocate the cost based on when it was paid by the Department. As this is an annual payment, changing the allocation would require retroactively adjusting all prior PALPOCs. **We recommend that the Department follow accrual basis accounting when preparing the PALPOCs and FALPOCs.**

Update on Prior Year Findings

Based on the revised 1998 FALPOC issued July 26, 2006, the actual power costs for 1998 were understated by $1.6 million. The adjustment for the undercharge was made within the Cost Allocation and Repayment Analysis System (CARA) and was initially planned to be included in the 2008 SOC. However, CARA was not used to generate the 2008 or 2009 SOCs. The Department now plans to include these charges in the December re-bill of the 2009 SOC. **We recommend the Department bill for additional costs in a timely manner. As noted above, timely billings would avoid potential cash flow difficulties due to improper matching as to when costs are being paid for and when the related revenues are being collected.**

SUSPENDED AND NON-CHARGEABLE COSTS

General Background

Suspended costs are those California Water Resources Development System costs for which the appropriate beneficiaries have not been contracted with and have not been charged. These costs are placed in a "Suspense Account," pending the beneficiaries' repayment agreements. Because of the very nature of these costs, the Department has not given the Contractors a commitment on the potential allocation of these costs. Any suspended cost not ultimately chargeable to the Contractors will be placed in a "Non-Chargeable Account" along with such costs as Capital Costs Settlements and the San Joaquin Valley Drainage Program. These costs will ultimately be charged against the State's equity in the SWP at the end of the project repayment period. The Monterey Amendment made provision for annual repayment of San Joaquin Valley Drainage program costs up to a set maximum annual amount of $4.5 million via the Capital Facilities account.

The following are descriptions of suspended items:

1. <u>Future Contractor – South Bay</u>
   This item includes capital and minimum costs to date for the unallocated capacity of the South Bay Aqueduct. Alameda County acquired a portion of this capacity in Reach 8. Consequently, all of the capital costs and the minimum costs from the date of acquisition were charged to Alameda County. Effective January 1, 2000, all of South Bay's capacity was permanently transferred to Zone 7. Zone 7 will pay for all South Bay's past and future capital payments, as well as all future minimum payments. The balance still in suspension relates to the minimum costs from 1962–1999, which were not included in the agreement with Zone 7.

2. <u>Future Contractor – San Joaquin Valley</u>
   These are costs not billed to Santa Barbara County due to the maximum Table A water reduction from 57,700 to 45,486 acre feet (capacity of 17 cfs). Santa Barbara requested an extension to "buy back" this capacity.

3. <u>Red Bank Project (Cottonwood)</u>
   These costs are related to the study that reviewed and investigated water supply projects on tributaries leading to Cottonwood Creek. This study evaluated the

potential of these projects, in combination with a Sacramento River bypass system, to control flooding.

4. Corporation Yard

These are costs incurred to purchase 17 acres of land in West Sacramento to consolidate the location of several offices (Mobile Equipment, Flood Maintenance, Bryte Laboratory, etc.). Due to a lack of General Fund money and uncertainty as to funding, the project was suspended.

5. Los Banos Grandes – Land Purchase

These costs are related to the potential off-stream storage reservoir. Mitigation of the land purchase is suspended until the degree and nature of each Contractor participation is determined. The land was sold for $861,500 in 2001; however, the purchase price less the sales proceeds still remains suspended.

6. Bay Delta Oversight Council

The Bay Delta Oversight Council and its related costs originated as a result of Governor Wilson's Water Policy Statement. The Council was funded out of project revenues and placed under the Department for administration. The organization no longer exists as it was supplanted with the subsequent establishment of the California Water Policy Council and Federal Ecosystem Directorate – Bay Delta Advisory Council (CALFED-BDAC). In October 1996, the activities of the Bay Delta Oversight Council were transferred to the CALFED-BDAC organization.

7. Drought Water Bank – EIR

Costs associated with preparing a program EIR for future water banks are compiled here. In the 1992–93 fiscal year, the Department began amortizing these costs over five years.

The following are descriptions of non-chargeable items:

1. Delta Crop Demonstration Program

These costs include management of the program, analyzing soil water measurements, monitoring of the wildlife mitigation measures and additional waste corn to offset waste grain reductions due to the demonstration program. Based on discussions with the Department, no efforts are being made toward the recovery of this cost.

2. Del Valle Flood Control

This represents the flood control allocation costs of Del Valle Dam and Reservoir, which was not reimbursed by the Federal Government. The Federal Government is not obligated to reimburse the SWP for these costs.

3. Capital Costs Settlements

These are non-reimbursable costs negotiated by the Department's Capital Cost Settlement Committee with the Contractors through fiscal year 1975–76. These are necessary SWP costs that produce substantial benefits outside the SWP. In accordance with Senate Concurrent Resolution No. 157 of the 1969 Legislature, the Department has informed the Senate and Assembly Water Committees of these negotiated costs.

4. San Joaquin Valley Drain

These are the costs of monitoring and reporting the quality and quantity of Ag waste waters in the San Joaquin Valley and the Los Banos Demonstration Desalting Facility, the latter of which was sold in November 2001. The San Joaquin Valley Drain is currently funded by the Monterey operating account. The Contractors continue to voice strong opposition to this project as it provides no benefit to the overall SWP. The Department has agreed in principle to reduce the level of expenditures in future years relating to this project. These costs were paid from the SWP capital facilities account established in connection with the Monterey Amendment. However, the Department has unilaterally moved these costs to O&M.

5. Auburn Dam

These are the costs of studying alternative sizes of Auburn Dam, the evaluation of the potential State financing, and construction of a down-sized Auburn Dam.

6. 1977 Exchange Water Program

These are unrecovered power credits given to the Metropolitan Water District, which are representative of the later block of water released by the Metropolitan Water District in anticipation of 1978 being another dry year.

7. Drought Information Center, Press Secretary

This item relates to the center that was constructed in the Headquarters' building to answer the public's and the press's questions about the drought. The center also provides Statewide reports. Operation of the center ended in late 1992 when the drought was declared to be over.

8. <u>CVP – Transfer</u>
   This item includes the negotiation of the terms and conditions of the contract between the Department and the USBR and other costs associated with the acquisition of the Federal CVP by the State.

9. <u>Cal Water Plan – CWF in lieu of General Fund</u>
   These are funds advanced by the California Water Fund (CWF) to develop Bulletin 160. The funds were advanced because of non-availability of General Fund monies.

10. <u>Jibboom Street – Water Operations Center</u>
   These are costs associated with the use of the PG&E Power Plant site on Jibboom Street for the proposed relocation of the Water Operations facility and a Visitors Center. In 2002, the Department sold the property to the City of Sacramento for $1 (see below).

<u>Procedures Performed</u>

- Obtained an update of the suspended and non-chargeable costs as of June 30, 2008.

<u>Findings and Results</u>

1) The following list of suspended costs are expected to be charged to project beneficiaries at some future date.

	Costs at June 30, 2008
Future Contractor – South Bay	$ 8,723,612
Future Contractor – San Joaquin Valley	8,597,838
Red Bank Project (Cottonwood)	1,934,624
Corporation Yard	1,582,908
Los Banos Grandes – Land Purchase	12,791,068
Bay Delta Oversight Council	20,669,070
Drought Water Bank – EIR	338,348
	$ 54,637,468

2) The following is a list of non-chargeable items (i.e., items not chargeable to project beneficiaries). Amounts will be written off against 4th Priority Revenues and the State's equity in the SWP at some time in the future.

	Costs at June 30, 2008
Delta Crop Demo Program	$ 145,548
Del Valle Flood Control	9,354,913
Capital Cost Settlements	11,847,268
San Joaquin Valley Drain	58,644,231
Auburn Dam	121,189
1977 Exchange Water Program	2,412,863
Drought Information Center, Press Secretary	126,042
CVP – Transfer	610,862
Cal Water Plan – CWF in lieu of General Fund	11,255,276
Jibboom Street – Water Operations Center	14,563,824
	$ 109,082,016

The foregoing should be of concern to the Contractors as the diversion of these funds from the SWP does not serve to reduce the CWF obligation, which was paid off in fiscal year 1999–2000. More importantly, the appropriation of SWP monies for suspended and non-chargeable programs reduces the available cash flow of the project, which could result in the Department having to incur further bond obligations and/or reduce amounts returned to the Contractors under the Monterey Amendment. In addition, nonfunded projects, such as those discussed, could adversely impact the Contractor's SOCs if billed. As of June 2008, the cumulative amount of $163.7 million was used to pay for suspended and non-chargeable projects. We will continue to monitor these costs as they become available.

These "non-chargeable" costs will ultimately be charged off against the State's equity in the SWP at the end of the project repayment period; **however, under the Monterey Amendment, any potential benefits of these nonchargeable or suspended costs will be lost. It should also be noted that the costs incurred relating to nonchargeable or suspensed projects continue to negatively impact the Department's cash flows and could ultimately impact RMCs.**

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0812-1013522_PLE